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STUDY TEXT

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PAPER F4

CORPORATE AND BUSINESS LAW (GLOBAL)

FOR EXAMS IN 2010

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S T U D Y T E X T

PAPER F4

CORPORATE AND BUSINESS LAW (GLOBAL)

In this edition approved by ACCA

- We **discuss** the **best strategies** for studying for ACCA exams
- We **highlight** the **most important elements** in the syllabus and the **key skills** you will need
- We **signpost** how each chapter links to the syllabus and the study guide
- We **provide** lots of **exam focus points** demonstrating what the examiner will want you to do
- We **emphasise key points** in regular **fast forward summaries**
- We **test your knowledge** of what you've studied in **quick quizzes**
- We **examine your understanding** in our **exam question bank**
- We **reference all the important topics** in our **full index**

BPP's **i-Learn** and **i-Pass** products also support this paper.

FOR EXAMS IN DECEMBER 2009 AND JUNE 2010

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NEW FEATURE – the PER alert!

Before you can qualify as an ACCA member, you do not only have to pass all your exams but also fulfil a three year **practical experience requirement** (PER). To help you to recognise areas of the syllabus that you might be able to apply in the workplace to achieve different performance objectives, we have introduced the '**PER alert**' feature. You will find this feature throughout the Study Text to remind you that what you are **learning to pass** your ACCA exams is **equally useful to the fulfilment of the PER requirement**.

Tackling studying

Studying can be a daunting prospect, particularly when you have lots of other commitments. The **different features** of the text, the **purposes** of which are explained fully on the **Chapter features** page, will help you whilst studying and improve your chances of **exam success**.

Developing exam awareness

Our Texts are completely **focused** on helping you pass your exam.

Our advice on **Studying F4** outlines the **content** of the paper, the **necessary skills** the examiner expects you to demonstrate and any **brought forward knowledge** you are expected to have.

Exam focus points are included within the chapters to highlight when and how specific topics were examined, or how they might be examined in the future.

Using the Syllabus and Study Guide

You can find the syllabus, Study Guide and other useful resources for F4 on the ACCA web site:

www.accaglobal.com/students/study_exams/qualifications/acca_choose/acca/fundamentals/cl/syllabus

The Study Text covers **all aspects** of the syllabus to ensure you are as fully prepared for the exam as possible.

Testing what you can do

Testing yourself helps you develop the skills you need to pass the exam and also confirms that you can recall what you have learnt.

We include **Questions** – lots of them - both within chapters and in the **Exam Question Bank**, as well as **Quick Quizzes** at the end of each chapter to test your knowledge of the chapter content.

Chapter features

Each chapter contains a number of helpful features to guide you through each topic.

Topic list

Topic list	Syllabus reference

Tells you what you will be studying in this chapter and the relevant section numbers, together the ACCA syllabus references.

Introduction

Puts the chapter content in the context of the syllabus as a whole.

Study Guide

Links the chapter content with ACCA guidance.

Exam Guide

Highlights how examinable the chapter content is likely to be and the ways in which it could be examined.

Knowledge brought forward from earlier studies

What you are assumed to know from previous studies/exams.

FAST FORWARD

Summarises the content of main chapter headings, allowing you to preview and review each section easily.

Examples

Demonstrate how to apply key knowledge and techniques.

Key terms

Definitions of important concepts that can often earn you easy marks in exams.

Exam focus points

Tell you when and how specific topics were examined, or how they may be examined in the future.

Formula to learn

Formulae that are not given in the exam but which have to be learnt.

PER alert

This is a new feature that gives you a useful indication of syllabus areas that closely relate to performance objectives in your Practical Experience Requirement (PER).

Question

Give you essential practice of techniques covered in the chapter.

Case Study

Provide real world examples of theories and techniques.

Chapter Roundup

A full list of the Fast Forwards included in the chapter, providing an easy source of review.

Quick Quiz

A quick test of your knowledge of the main topics in the chapter.

Exam Question Bank

Found at the back of the Study Text with more comprehensive chapter questions. Cross referenced for easy navigation.

Studying F4 (Global)

In approaching the F4 (Global) exam you should bear in mind what the paper is about, the skills you are expected to demonstrate in the exam and how you can improve your chances of passing the exam. We shall look at each of these points in turn.

1 What F4 is about

The main aims of the F4 (Global) exam are:

- To develop an understanding of the general legal framework in which international business takes place and of specific legal areas relating to business, but
- To recognise the need to seek further specialist legal advice where necessary

The exam is not designed to turn you into a legal expert. Instead you will be a well-informed professional accountant who appreciates the legal issues of doing business internationally but who recognises the boundaries of their legal knowledge and therefore the point at which professional legal expertise must be sought.

The sequence of the syllabus and study guide takes you through the main areas of what you need to know.

Essential elements of legal systems

In this part of the syllabus you are covering areas that underlie all the other areas, namely: what is law and how does it fit into a country's political, economic and legal system. The distinctions between criminal and civil law, and between common law, civil law and sharia law systems, are very important. Most of the paper is concerned with civil law, namely the law that sets out the rights and duties of persons in relation to each other. There are elements of criminal law as well, however, especially in relation to companies, insolvency, insider dealing and international money laundering.

The distinction between public and private international law is also important, affecting as it does the status of the various UN Conventions and Model Laws that are contained in the syllabus. These are intended at least in part to address the problem of private international law, namely the conflict of laws.

International business transactions

The central part of this section of the syllabus is concerned with the international sale of goods, covered by the UNCITRAL Convention on the International Sale of Goods. Its detailed provisions cover formation of the contract, the obligations and remedies of the buyer and seller, the right to damages, and rules on matters such as unexpected impediment and the passing of risk.

In any sale of goods the seller wants to make sure they get paid, and international trade operates much more effectively if it is properly financed. There is a variety of means of payment, such as letters of credit, credit transfers and bills of exchange. This is an area in which international bodies have been very active, so there is a Convention and a Model Law to be studied.

International business forms

In addition to the finance and expedition of international trade, the syllabus is very concerned with the various legal forms through which international business transactions may be conducted. It is important to distinguish initially between natural persons and legal persons. The law of agency underlies a substantial part of our study of international business forms, since partners and directors can and sometimes do act as agents. There is a Model Law on agency, but the different forms of partnership that exist around the world are not regulated by Model Laws or Conventions.

Joint stock companies

Companies are probably the most common form of business engaged in international trade but the detailed rules surrounding their formation and constitution are regulated by each country slightly differently. In this text we look in detail at company law in the UK as exemplar of possible regimes. Companies are separate legal persons. Most commonly their owners have limited liability for the company's debts, although this position can be ignored if certain circumstances exist. This means that when dealing with a company as a seller or a buyer, say, the other party should ideally have knowledge of

their constitutions and their finances. In fact the price of separate legal personality for a company's shareholders is that information on these matters is publicly available, for the protection of suppliers, customers and other stakeholders.

Capital and financing of companies

Most trading companies are financed by a mix of share capital (provided by their owners) and loan capital (provided by third party lenders). Share capital may take a variety of forms, with each class of share having different rights within the company. However, the primary responsibility of the shareholder is to contribute funds to the company in accordance with the terms of the company's constitution and the shares which they own.

Loan capital is usually provided by lenders only if they can be assured of its repayment to them. If lenders supply funds in return for debentures in the company, this usually means that they have security for their loan: the debenture is secured by means of a registered charge on particular or general assets of the company, which can (within limitations) be realised so that the loan is repaid.

Management, administration and regulation of companies

As an artificial legal person a company cannot manage itself. This is the role primarily of the company's directors, who owe duties to the company to manage it for the benefit of the company and thereby for the benefit of its owners, the shareholders. There are a great many legal rules which regulate the appointment, remuneration, disqualification, powers and duties of directors. These have grown up largely because of problems that frequently occur. Directors are termed officers of the company along with the company secretary. Many companies also have to have an auditor.

Directors come into immediate contact with shareholders via company meetings, and the resolutions that are passed at these meetings. There is therefore a plethora of legal rules on meetings and resolutions, designed to ensure that the company is taking decisions properly and in accordance with the legitimate interests of shareholders as a body.

Companies in difficulty or in crisis

Not everything goes according to plan and frequently companies will encounter financial or other difficulties, or will even reach crisis point and find themselves insolvent. At this point all parties – shareholders, directors, lenders, customers, suppliers and employees – are in danger of losing out. There are procedures designed to protect struggling companies to give them a 'breathing space' while they resolve their issues. There are also rules for how a company which cannot be saved should be 'wound up', depending on whether or not the company has any funds left. Companies which have international dealings have long presented particular legal problems: where should they be wound up, which creditors should get paid, where are the assets and how can they be realised? The UNCITRAL Model Law on Cross-border insolvency is designed to co-ordinate and simplify insolvency proceedings which cross international boundaries.

Corporate governance

Corporate governance means trying to ensure that companies are well-managed and controlled. While there are plenty of legal rules designed to ensure good corporate governance, in most jurisdictions there are also (semi-)voluntary codes of practice which apply to some but not all companies. In the UK the Combined Code on Corporate Governance applies to all companies listed on the London Stock Exchange, but is also recommended to other companies. It seeks to protect shareholders and address the problems of conflicts of interest in part by implementing the principle of separation of duties between executive and non-executive directors. It also covers directors' remuneration, external audit, nominations to the board of directors and other issues. In some other jurisdictions greater emphasis in corporate governance is placed on protecting the interests of all stakeholders, such as suppliers and employees, not just shareholders. The Sarbanes-Oxley Act in the US is a statutory attempt to regulate good corporate governance and to crack down on criminal behaviour in the way companies are run.

Fraudulent behaviour

Finally the syllabus covers the situations where activities of directors and others have strayed into criminal behaviour. This often arises in the context of companies running out of money, but the law is also concerned with company insiders with superior knowledge benefiting from insider dealing, and international crime in the form of money laundering.

2 What skills are required?

To pass the F4 (Global) exam you will need to bring a number of different professional attributes to bear.

First, you need **technical knowledge**. There is a huge amount of technical content in the syllabus: model laws, Conventions, codes of practice, and legislation. You need to learn this and be able to identify which parts of the knowledge you have are being called for in a particular question.

Second, you need to be able to **apply knowledge** to the scenarios that are presented in the last three questions on the paper. You are aiming to solve practical problems here. Generally in scenario questions there will be marks available for stating the law, identifying the issues in the scenario in relation to the law, applying the law and reaching a conclusion.

Third, you need **written skills** in order to be able to explain, and advise on the basis of, your technical knowledge. Explaining means providing simple definitions and covering why and how these approaches have been developed. You'll gain higher marks if your explanations are clearly focused on the question and you can supplement your explanations with examples.

3 How to improve your chances of passing

To pass the exam you need to **cover the syllabus thoroughly**. The exam requires you to answer all TEN questions on the paper. Each topic that you fail to cover represents 10% fewer marks in the exam.

You should **practise answering questions** as much as possible, making sure that your answers are focused, specific and completely relevant to the question.

Ten questions is a lot to answer in three hours so your **exam technique** is very important, especially:

- Strict **time management:** only 18 minutes per answer
- Deciding on **the order in which you attempt questions** carefully: use your 15 minutes' reading and planning time carefully to make sure that you attempt your best topics first when you start to write. This will bolster your confidence and help to ensure that you manage your time properly, so long as you don't overrun your time allocation on the early, 'better' questions
- **Reading the question** carefully: make sure you identify precisely what aspect of the UNCISG is being asked for, say

  Only **answering the question set**: do not stray into irrelevant areas of, say, the UNCISG. You will gain no marks and you will lose time.

4 Examinable documents

Legislation passed by 30th September 2008 will be examinable in December 2009. Legislation passed after this date will be examinable in June 2010. Unless otherwise stated, material in this text is valid in both sittings.

5 Practical Experience Requirement (PER)

The laws and regulations that you are about to study underpin many of the performance objectives that you need to complete. Where appropriate these links are identified, however you should bear in mind that others may be equally valid and you should look to integrate the law into these objectives where possible.

The exam paper

Format of the paper

The examination is a three-hour paper consisting of seven, ten-mark questions testing knowledge and three, ten-mark application (scenario) questions.

Guidance

As all questions are compulsory it is vital to attempt all of them. Even if you are not confident about an area of law, it is often easier to earn marks by stating a question and putting something down, than by adding material to an already developed answer.

When answering scenario questions follow the **ISAC** approach.

Identify the legal issues
State the relevant law
Apply the law
Conclude

This structure will maximise your marks as you identify what the problem is, state what the law says about the problem, apply the law and come to a reasonable conclusion – exactly what the examiner wants.

You are expected to quote case names and section numbers in your answers. Do your best to learn as many as you can (at least a handful in each topic area), but don't worry if in the exam you forget the case name or section number – as long as you correctly state the principle of law you will earn most of the marks.

Company law

Many students have failed this exam because they refer to out-of-date company law. This text is based on the latest (Companies Act 2006) so you are assured the material you are about to study is up-to-date.

Analysis of past papers

The table below provides details of when each element of the syllabus has been examined and the question number and section in which each element appeared. Further details can be found in the Exam focus points in the relevant chapters.

Covered in Text chapter		Dec 2008	June 2008	Dec 2007	Pilot Paper
	ESSENTIAL ELEMENTS OF LEGAL SYSTEMS				
1	Economic, political and legal systems	1		1	
2	International trade and regulation		1		1
3	Commercial arbitration	2		1	2
	INTERNATIONAL BUSINESS TRANSACTIONS				
4	Contracts for the international sale of goods	8	2	2, 3, 8	3, 8
5	Obligations and risk in contracts for international sales	3	3,8	2,3	4, 8
8	Transportation and payment	7	7	6	
	INTERNATIONAL BUSINESS FORMS				
7	Agency				
8	Sole traders and partnerships	10	9		
	JOINT STOCK COMPANIES				
9	Corporations and legal personality		4		
10	Company formation				
11	Constitution of a company	9		4	
	CAPITAL AND FINANCING OF COMPANIES				
12	Share capital	4	5	9	9
13	Borrowing and loan capital		5		
14	Capital maintenance and dividend law			5	
	MANAGEMENT, ADMINISTRATION AND REGULATION OF COMPANIES				
15	Company directors and other company officers	6	6	7, 10	5
16	Company meetings and resolutions	5			6
	LEGAL IMPLICATIONS RELATING TO COMPANIES IN DIFFICULTY OR IN CRISIS				
17	Insolvency and administration			9	
	GOVERNANCE AND ETHICAL ISSUES RELATING TO BUSINESS				
18	Corporate governance				7
19	Fraudulent behaviour		10		10

PART A

Essential elements of legal systems

1

Economic, political and legal systems

Topic list	Syllabus reference
1 The concept of global law	A1(a)
2 Economic systems	A1(a)
3 Political systems: separation of powers	A1(a), A1(b)
4 Legal systems	A1(a)
5 Criminal law	A2(a), A2(b)
6 Civil law	A2(a), A2(b)
7 Common law systems	A2(c)(i)
8 Civil law systems	A2(c)(ii)
9 Sharia law systems	A2(c)(iii)

Introduction

In this chapter we will be looking at the overall **context** – **economic, political and legal** – in which international law exists. There is no all-encompassing global law as such; instead there are **national legal systems** (of three kinds: **common law, civil law and Sharia law**). These may be contradictory (creating the problem of **conflict of laws**), therefore some **model international laws** have been put together by international organisations such as the United Nations to resolve the problem. In these ways the relations between states, and between individuals in different states, are regulated

The kind of legal system used by a country depends on historical and cultural factors, and to some extent on economic and political factors. Whatever the legal system, we will be looking in particular at: **principles of law**, **sources of law** and **the role of judges**.

Study guide

		Intellectual level
A	**Essential elements of legal systems**	
1	**Economic, Political and Legal Systems**	
(a)	Explain the inter-relationship of Economic and Political and Legal systems	2
(b)	Explain the doctrine of the separation of powers and its impact on the legal system	2
2	**Different legal systems**	
(a)	Differentiate between different types and different systems of law	1
(b)	Explain the distinction between criminal and civil law	1
(c)	Outline the operation of the following legal systems: (i) Common law (ii) Civil Law (iii) Sharia law	1

Exam guide

Each topic in the study guide should be regarded as highly examinable, usually by a knowledge-based question.

1 The concept of global law

FAST FORWARD

There are some **model international laws** that regulate the relationship of sovereign states, and their rights and duties with respect to each other. Most law, however, consists of **national laws**, which nevertheless follow certain **common methodologies**.

Exam focus point

Exam questions on the topics in this chapter are most likely to be looking to test your knowledge and understanding of distinctions, and so are unlikely to be scenario-based. You may be asked to list and contrast different factors, such as the role of judges or the sources of law in the three different legal systems (as in December 2008).

1.1 Model international laws and exemplar national laws

Although 'law' is a global concept, it is **usually organised on national lines**, and there is only a **limited amount of truly international law**. In this Study Text we shall consider some **national laws that have been examples** for other countries developing their legal systems. These may therefore indicate the practice of law in many countries worldwide. We shall also see **model laws that have been developed by international bodies** and which have been adopted by various countries so that nations may interact with one another more easily.

First of all we shall look in general terms at **how nations have ordered their own legal systems**. We shall give examples of a number of nations, but we shall by no means be comprehensive in world terms.

Attention!

If you are studying in a country to which we do not make reference, find out the origins of your nation's legal system, so that you can compare it to the ones we lay out here. Remember that you are not going to be examined on any one nation's legal system, rather you will be examined on **principles of law that have international significance**.

FAST FORWARD

There are **three key legal systems** or **underlying methodologies of law** operating in the world that have been adopted by different countries for different reasons: common law, civil law and Sharia law.

1.2 Common law

Common law is a system named after a **historic system formulated in England**. The terminology associated with this system can be confusing. You will find that the legal system is named after one distinctive source of law within itself, but that the system comprises several sources of law. Common law systems developed in **England**, but have been **exported to many ex-British empire and Commonwealth countries**, notably, for our purposes, the **United States of America**.

1.3 Civil law

Civil law systems originated in **continental Europe**, but have similarly been exported through world empires and so are equally prominent in other world areas, for example, **South America**. Civil law systems are much younger than common law ones, although they come from equally old legal heritages. We shall use **France** and **Germany** as exemplar of these systems. Increasingly in modern times, civil and common law systems share common elements, although historic differences have a conceptual impact.

1.4 Sharia law

Sharia law is significantly different from both common and civil law systems. It is a legal system **bound up in the religion of Islam**, which makes it **different in both purpose and practice**. It has influence in many Islamic countries worldwide, and has been adopted as a comprehensive legal system in some. We shall look at two exemplar countries where such adoption has taken place: **Pakistan** and **Iran**.

1.5 The effects of economics and political systems on legal systems

Business activity takes place within a particular **economic**, **political** and **legal context**, and each of these areas will affect each other to an extent. The economic and political context of each nation is not the same (although many groups of nations are similar) and therefore nations' legal systems vary considerably from one another.

The **differences** between the nations, in terms of economics, politics and, most importantly for this syllabus, law, can present **problems** for **international trade**. In this Study Text, we shall explore the difficulties presented and the solutions created by various international bodies, particularly the United Nations, which we introduce in Chapter 2.

2 Economic systems

FAST FORWARD

Economics can be described as the ways in which society decides **what to produce**, **how to produce it** and **who to produce it for**. There are three basic kinds of economic system – planned, market and mixed economies.

Each **individual** is involved in economics, in 'providing' (by salary or labour) for himself and his family. On a wider scale, **governments** are involved in economics for the whole country. There are various types of economic system that might exist in a country: **planned**, **market** and **mixed**.

2.1 Planned economy

A **planned economy** exists where the decisions and choices about resource allocation are made by the government. Money values are attached to resources and to goods and services, but it is the government that decides what resources should be used, how much should be paid for them, what goods should be made and what their price should be. Although the individual might be allowed to own some personal possessions, most kinds of wealth would not be available for ownership by individuals.

2.2 Market economy

A **market economy** exists where the decisions and choices about resource allocation are left to **market forces of supply and demand**, and the workings of the price mechanism. In the market economy, most wealth is owned by individuals, with a minimum being collectively owned.

2.3 Mixed economy

In a **mixed economy**, decisions and choices are made partly by free market forces of supply and demand, and partly by government decisions. Economic wealth is divided between the private sector and the public sector. In practice, all modern national economies are mixed economies, although with differing proportions of free market and centrally planned decision-making from one country to the next.

3 Political systems: separation of powers

FAST FORWARD

Political systems affect legal systems. There may be a **democracy** or a **dictatorship**, which generally influences the **nature of the rule of law** in the nation. In democratic systems there is usually **separation of powers** between the head of state, the executive, the legislature and the judiciary. In dictatorial systems some or all of these powers may be combined so that one person or party has total power.

We have already referred to the role of government in national economics. Governments, as we shall see, are also heavily involved in law-making. Politics, the process of how nations are governed and by whom, is clearly relevant to how law is developed.

Law-making can be a **democratic** process, where law is developed by citizens, or a more **dictatorial** process, where law is developed by a government put in place by another method, for example military coup.

What process is in force in a nation also affects two very important factors: the **rule of law**, and the **separation of powers**.

3.1 The rule of law

How and what laws are made and enforced in a country depends to a large extent on the emphasis that the country's political system places on the nature of the **rule of law**. This is the degree to which individual behaviour is regulated by law.

In **dictatorial** systems there tends to be emphasis on state or government regulation and control of resources. This means individual freedom is heavily subject to the rule of state-made law, and the behaviour of individuals is to a large extent dictated by the state by means of law.

In more **democratic** or *laissez-faire* political systems, the emphasis is on the law being a means of sorting problems out where they arise. Provided individuals act within the letter and spirit of the law, they are free to choose for themselves how they regulate their lives and how they relate to other people and groups.

3.2 Separation of powers

The concept of the 'rule of law' is closely bound up with that of **separation of powers**. Most 'consensual' democratic nations in the world have power held in different places, so that no part of the political process holds too much influence. They usually have:

- An elected **legislature**, a body which decides on what laws should be passed to ensure that the people's wishes – for freedom, wealth etc – are met;
- An elected **executive**, or government body, which makes the decisions that put the laws into action;
- A **judiciary** (which may or may not be elected) that rules on any disputes about laws, whether between the government and the people (**criminal law**) or between individuals (**civil law**).

In some nations – such as the US – the **legislature**, the **executive** and the **judiciary** are completely separate. Therefore each is accountable to, and can operate as a 'check and balance' on, the others. In most states, such as the UK, there is a **complex relationship** between the three sets of powers. This means that a balance is struck between control and accountability, on the one hand, and actually 'getting things done' on the other.

The other separation of powers that is frequently seen is where the person who is **head of the executive** is **not** the same person as the **head of state**. In most European nations for instance the two persons are separate. In the UK the head of state is the monarch, while the head of the executive is the Prime Minister. In France there is the President and the Prime Minister. In the US, on the other hand, the President is both head of state and head of the executive.

4 Legal systems

FAST FORWARD

'Legal systems' can be used in **two** senses: to describe the body of laws and mechanisms for their enforcement in a country, and to describe the underlying nature of a country's law.

4.1 What is a legal system?

A legal system in a country embodies both the **laws** of that country and the **mechanisms** the country has in place for regulating and enforcing those laws. Thus a legal system incorporates:

- The country's **laws**
- The **legislature**: the law-making body
- The **judiciary**: the body that sits in judgement on disputes about laws
- The **prosecution system**: the system that seeks to ensure the criminal law is enforced and people who break the law are prosecuted
- The **police**: the body which seeks to enforce the law and protect the public
- The **prison** system: the system that ensures people who have broken the criminal law are detained in accordance with their sentence

The term **'legal system'** is also used to describe the **underlying nature of the country's law**. It is in this sense that we shall be using the term later in this chapter.

Before embarking on the rest of your studies for this paper and undertaking the exam, it is vital that you have an understanding of what **international law** is, and how the various aspects of this syllabus fit together. In order to do so, it will be necessary even to consider what law itself is, and to understand some key terms taken from the Oxford Dictionary of Law.

4.2 What is law?

FAST FORWARD

Law is the enforceable body of rules that govern any society. **Positive law** is the body of law imposed by the state.

Law is a body of rules that enables society to operate. As such, it **does not have to be written down**, but can be simply rules that everyone in the society knows. Given the sheer size of the world, then, **law has not historically been seen in global terms**, but rather in manageable 'societies'.

Both far back in human history and today in some societies, law has been seen in terms of **families and tribes**. More recently in much of the world, it has been seen in terms of **nation states**. Many states have **written constitutions** outlining citizens' basic legal rights, and a body of **national law**, or rules, which governs how the state operates. This is known as **positive law**.

4.3 Types of law

FAST FORWARD

The main distinctions to be made between types of law are between **national** and **international** law, and between **criminal** and **civil** law.

Each nation state has a set of laws which regulate how entities relate to each other and to the state, in their own country, known as **national law**. This is distinct from **international law**, which reflects the interrelationship of sovereign states, and which attempts to resolve the problem of **conflict of national laws**.

Within each state, and increasingly across national boundaries, there is also a distinction between **civil law** and **criminal law**. We shall come back to this shortly.

4.4 Conflicts of laws

In addition to the existence of positive (state) or national law, individuals and corporations interact with one another globally, and that has lead to **conflict of laws**. This occurs in situations where people from different states, with different legal rules, have been in relationship with each other.

While nations have interacted happily with one another over many years, improved **communication systems** resulting in increased **international trade** and other **relationships** has prompted moves by various bodies to develop international legal systems and understandings with each other.

FAST FORWARD

Conflict of laws occur when people from different legal jurisdictions trade with each other and their respective legal rules conflict. **International law** is the system of law regulating the interrelationship of sovereign states and their rights and duties with regard to one another.

Certain international organisations (such as the **United Nations**), **companies** and sometimes **individuals** (for example, in the area of human rights) may have **rights or duties under International law**.

International law is the system of law regulating the relations between sovereign states, and the rights and duties they have with regard to each other.

International law deals with matters such as:

- The formation and recognition of states
- Acquisitions of territory
- War
- The law of the sea and of space
- Treaties
- Treatment of aliens
- Human rights
- International crimes and international judicial settlement of disputes

Attention!

International crime and **judicial settlement of disputes** are issues on our syllabus, and we shall look at them specifically at the appropriate time. We shall also look in more detail at some of the international bodies promoting international law development in Chapter 2.

4.5 Sources of international law

FAST FORWARD

Sources of international law are **public** (treaties, custom and general legal principle) and **private** (a nation's own national laws which regulate international dealings).

There are various **sources** of **international** law:

- Conventions and treaties
- International custom
- The general principles of law recognised by civilised nations

For example, the **European Union** is a collection of nations which have agreed between them on some common laws by signing Conventions and Treaties. This is **public international law**. You may also come across the term **private international law**, which is the part of a nation's own law that establishes rules for dealing with cases involving a foreign element.

4.6 Types of legal system

As we have discussed above, law is usually organised on national lines. There are **three main ideologies**, or **legal systems**, which underlie state systems of law: common law. These are **civil law** and **Sharia law** systems. We shall introduce these three key systems later in this chapter, but first we shall look in more detail at the distinction between two key types of law: the criminal and the civil law.

5 Criminal law

FAST FORWARD

A **crime** is conduct prohibited by the law. It is usually **punished** by the State, which **prosecutes** the case, by means of **fines** or **imprisonment**. There is usually a **heavy burden of proof**.

In a criminal case the State is the prosecutor because it is the community as a whole which suffers as a result of the law being broken. **Persons guilty of crime may be punished by fines payable to the State or imprisonment**. In some circumstances the court may make a compensation order, by which the criminal must pay some compensation to the victim or their family.

In the UK, the **police** or the **Director of Public Prosecutions** take the initial decision to prosecute, but this is then reviewed by the **Crown Prosecution Service**.

In a criminal trial, the **burden of proof** to convict the **accused** rests with the **prosecution**, which must prove its case **beyond reasonable doubt**.

In the UK and parts of the Commonwealth, a **criminal case** might be referred to as *R v Smith*. The prosecution is brought in the name of the Crown (R signifying *Regina,* the Queen). In the US, it might be referred to as *State v Smith.*

As we discussed in the introduction, what is considered a **crime** will vary from state to state. Other differences include the types of punishments delivered to guilty parties, the degree of evidence required to convict someone of an offence, and the extent to which the court may order the guilty criminal to compensate the victim.

In resolving criminal issues, the outcome is usually punishment of the wrongdoer, although a compensation order may be made in some circumstances. Some legal systems based on Sharia or Islamic law (which we will see in detail shortly) contain the concept of **qisas**, or **retribution**. In certain cases these give a legal right to inflict on the wrongdoer the same hurt as he has perpetrated on the victim, or to accept **diyat**, **compensation**, instead.

This provides some **compensation** to the victim of criminal activity, who is not necessarily considered in Western law. In the West, the focus of the law is mainly to punish the wrongdoer, and where victims might have to undertake a civil law action to receive significant compensation.

6 Civil law

FAST FORWARD

Civil law exists to regulate disputes about the rights and obligations of persons when dealing with each other. The State is not party to a civil case, and there is a lighter burden of proof.

In civil proceedings, the case must usually be proven on the **balance of probability,** to convince the court that it is **more probable than not that the assertions are true**.

Terminology in civil cases is different from that in criminal cases. The **claimant** sues the **defendant**. A civil case would therefore be referred to as, for example, *Smith v Megacorp plc.*

One of the most important areas of civil liability for business, and accountants in particular, is the law of **trade and contract**.

Attention!

> We shall be looking at the international laws relating to trade in Chapters 2 to 6 of this Study Text. It is therefore important for you to understand the nature of civil law, as opposed to criminal law, it is a type of law existing in all legal systems.

6.1 Distinction between criminal and civil cases

It is not an act or event which creates the distinction between criminal and civil cases, but the **legal consequences**. A single event might give rise to criminal and civil proceedings.

A broken leg caused to a pedestrian by a drunken driver is a single event which may give rise to:

- A **criminal case** (prosecution by the State for the offence of driving with excess alcohol), and
- A **civil case** (the pedestrian sues for compensation for pain and suffering)

The two sorts of proceedings are usually easily distinguished because three vital factors are different:

- The **courts** where the case is heard
- The **procedures**
- The **terminology**

In criminal cases the **rules of evidence** are usually very strict. For example, a confession will be carefully examined to see if any pressure was brought to bear upon the accused. An admission in a civil case will not usually be subjected to such scrutiny.

Question — Criminal and civil law

While on a sales trip, one of your employees is involved in a car accident. The other vehicle involved is damaged and it is alleged that your employee is to blame. What legal proceedings may arise as a result of this incident?

Answer

Your employee may be guilty of a driving offence such as careless driving. The police, to whom the incident should be reported, will investigate, and if the facts indicate a driving offence, will prosecute him. The owner of the damaged vehicle (or his insurers) may sue the driver at fault in civil proceedings to recover damages.

Point to note

> We will look at areas of both criminal and civil law in this Study Text. You should be aware that in some legal areas looked at in this Study Text, both types of law might be relevant. For example, as we shall see, in the area of company law, both criminal law (for example, insider dealing, fraudulent trading) and civil law (for example, 'passing-off') will be relevant.

7 Common law systems

Common law systems derive from, and are named after, the **law developed in England** between **1066 AD** and about **1400 AD**.

Although the law was developed in England, it has been exported globally as a result of the British Empire and Commonwealth. It is the basis of the legal system of the United States of America (US). We shall use **England** and the **US** as exemplar of the system.

Attention!

You should note that England has been part of what is now the United Kingdom (UK) for over three hundred years. Some of England's legal system remains peculiar to itself within that kingdom, but many of the modern aspects are common to all the nations in the kingdom (England, Scotland, Northern Ireland and Wales), and you will find both England and the UK referred to in this Study Text.

7.1 Principles of common law

FAST FORWARD

Common law builds up over time, added to by the legislature (statutes are presumed to add to, not alter, existing law) and by **judicial precedent**.

In English law, **principles of law** do **not become inoperative** through the **lapse of time**. In other words, law does not become irrelevant and invalid just because it is old. This applies to all sources of the law. Also, **new laws developed by the legislature (Parliament) are presumed not to alter**, merely to add to, **the existing law**, unless they specifically state that they do.

Another important principle of common law is the concept of **judicial precedent**, which we shall look at in more detail below in the context of **judges**.

Key terms

A **precedent** is a previous court decision which another court is bound to follow by deciding a subsequent case in the same way.

The doctrine of **judicial precedent** means that a judge is bound to apply a decision from an earlier case to the facts of the case before him, provided, among other conditions, that there is no material difference between the cases.

7.2 Sources of law in common law systems

There are various sources of law in England:

- Common law (from which the legal system derived its name)
- Equity – based on case law
- Statute
- Custom (of little modern significance, so we shall not consider it any more)
- European Union law (we shall not explore EU law further in this section)

European Union law is not a source of law in the US as it has not been a party to the treaties with other European countries that the UK has. The US, however, does have a significant additional source of law, the **American Constitution**. The UK does not have a written constitution.

Common law and equity form what is known as **case law**. Case law is a significant difference between the common law system and the civil law system. We shall consider it in detail later on in connection with the role of judges.

Attention!

Equitable principles supplement and improve the **common law**. Both are based on **case law** and **statutes** from the national and EU parliament – an additional source of law.

7.2.1 Common law

At the time of the Norman Conquest in 1066 there was no system of law common to the whole country. Rules of local custom were applied by local manorial courts. To improve the system, the King sent **royal commissioners** on tour to deal with crimes and civil disputes. At first, these commissioners applied the local customary law of the neighbourhood. On their return from circuit they sat in the royal (known as **common** law) courts at Westminster to try cases there.

In time the commissioners in their judicial capacity developed rules of law. These (known as common law) were selected from the differing local customs which they had encountered, and which they applied uniformly in all trials (before the King's courts) throughout the kingdom.

There were a number of problems with the system of common law on its own:

(i) Common law was often **inflexible**. Before he could bring an action, a claimant had to obtain a **writ** (an order issued under the King's authority). Writs covered only a limited number of matters. If there was no appropriate writ form, an action could not be brought.

(ii) Only a **limited remedy**, damages (compensation), was available. Common law could not stop a person doing something or compel him to do something.

(iii) There was **too much emphasis on procedure**. A claimant might lose his case because of a minor technicality or wording. The system was open to bribery and corruption.

7.2.2 Equity

As a result of these problems with the common law, a parallel system of **complimentary law** was developed. Citizens who could not obtain redress for grievances in the King's common law courts petitioned the King to obtain relief by **direct royal intervention**. These petitions came before the King in Council and by custom were referred to the principal civil minister – the Chancellor.

In dealing with each petition the Chancellor's concern was to establish the truth of the matter and then to impose a **just solution** without undue regard for technicalities or procedural points. Because the principles on which the Chancellor decided points were based on fair dealing between two individuals as equals, it became known as **equity**.

The system of equity was **not a complete alternative** to the common law. It was a **method of adding to and improving on the common law**. Both sources of law are administered in the same courts. These two historic sources of law form **case law** (law made by judges). We shall look at the role of judges in applying the rule of judicial precedent below.

7.2.3 Statute

Key term

Statute law is made by Parliament (or in exercise of law-making powers delegated by Parliament, known then as delegated legislation or, in the civil law system (see later) administrative regulations).

Until the UK entered the European Community (now the European Union) in 1973 the UK Parliament was completely **sovereign** – its law-making powers were unfettered, and there was **no written constitution**.

In that respect there was a marked contrast with the position in some other countries, such as the US. Here there is a written constitution and it is possible to challenge in the courts (as unconstitutional) legislation made by the statutory law-making body.

In recent years however, UK membership of the **European Union** has restricted the previously unfettered power of Parliament. There is an obligation, imposed by the Treaty of Rome, to bring UK law into line with the Treaty itself, and with **directives made by the European Commission or Council**.

On certain subjects the EU may make **regulations** under provisions of the Treaty of Rome. These have direct force of law in EU states, and do not have to be enacted by statute.

The UK tradition is to **draft statutes in comprehensive detail** to attempt to cover all eventualities that the statute is designed to cover.

7.2.4 Codification in common law systems

From time to time, Parliament will produce a **codifying statute**, which puts common law in an area on a statutory footing. In that respect, codifying statutes are similar to civil law codes, which we shall consider later.

However, codification is not common in England, and many areas of law, for example, contract law, still largely derive from common law.

7.2.5 American Constitution

The American Constitution was mentioned earlier. It is the ultimate source of law in the US. Any statute passed by the American Senate, by the federal government or in individual states may be challenged by a citizen on the grounds that it is unconstitutional.

Attention!

> The US Constitution sets out the basic rights of US citizens and the systems of government for them. You can access it on the Internet, for example, at www.usconstitution.net.

7.3 Role of judges in common law systems

FAST FORWARD

> Judges play two roles in building up **case law** in common law systems – by setting and applying **judicial precedent**, and, by **interpreting statutes**, they also perform the important function of **judicial review**.

7.3.1 Judicial precedent in case law

It is generally accepted that **consistency** is an important feature of a good decision-making process. Judges are required to treat similar cases in the same way.

A judge's decision is expected to be **consistent with previous decisions**. It should provide an opinion which the parties, and others, can use to direct their future relationships as it creates law. This is the basis of the system of **judicial precedent**, which we introduced above.

Judicial precedent is based on three elements.

- **Reports.** There are comprehensive law reports of earlier decisions.
- **Rules.** There must be rules for extracting a legal principle from a previous set of facts and applying it to current facts.
- **Classification.** Precedents must be classified into those that are **binding** and those which are merely **persuasive**. (Decisions of lower courts are never binding.)

Four **rules** must be considered when examining a precedent before it can be applied to a case.

- A decision must be based on a **proposition of law** before it can be considered as a precedent. It may **not** be a decision on a **question of fact**.
- It must form part of the ***ratio decidendi*** of the case.
- The **material facts** of each case must be the same.
- The preceding court must have had a **superior (or in some cases, equal) status** to the later court, such that its decisions are binding on the later court.

Key term

> 'The ***ratio decidendi*** of a case is any rule of law expressly or impliedly treated by the judge as a necessary step in reaching his conclusion, having regard to the line of reasoning adopted by him, or a necessary part of his direction to the jury.' (Cross: *Precedent in English Law*)

The English legal system comprises a **hierarchy of courts**. In terms of the status of the courts for precedents, you should be aware that lower courts do not create binding precedents. They are bound by the decisions of higher courts, each of which is bound by the courts higher to itself. You can see the hierarchy of the courts in Chapter 2.

A precedent in a previous case can be avoided by a judge if he '**distinguishes on the facts**'. This is connected with the third rule above. A precedent is only binding if the material facts of the later case are the same as the previous case. This is a matter of judicial judgement.

Precedents may also be **overruled** by higher courts than the court that set them. This tends to be rare, particularly if the precedent has existed for a long time.

Question

What do you think are the advantages of case law as a source of law in common law systems?

Answer

The law is decided fairly and **predictably**, so that business people and individuals can regulate their conduct by reference to the law. The **risk** of mistakes in individual cases is reduced by the use of precedents. Case law can **adapt** to changing circumstances in society, since it arises directly out of the actions of society. Case law, having been developed in **practical** situations, is suitable for use in other practical situations.

7.3.2 Statutory interpretation in case law

When deciding cases based on statute law, **judges will be required to interpret the statutes that Parliament has enacted**. There are various rules and presumptions associated with the interpretation of statute.

Presumptions of statutory interpretation:

- **Statutes do not override existing law** on a subject unless they specifically state that they do so. In other words, statutes are generally seen to **supplement existing case law**.
- **A statute does not alter the existing common law**. If a statute is capable of two interpretations, one involving alteration of the common law and the other one not, the latter interpretation is to be preferred.
- **If a statute deprives a person of his property**, say by nationalisation, he is to be compensated for its value.
- **A statute is not intended to deprive a person of his liberty**. If it does so, clear words must be used. This is relevant in legislation covering, for example, mental health and immigration.
- **A statute does not have retrospective effect** to a date earlier than its becoming law.
- **A statute does not bind the Crown**. In certain areas, the Crown's potential liability is great and this is therefore an extremely important presumption.
- **A UK statute has effect only in the UK**. However, a statute does not run counter to international law and should be interpreted so as to give effect to international obligations.
- **A statute cannot impose criminal liability** without proof of guilty intention. Many modern statutes rebut this presumption by imposing strict liability, say for dangerous driving under the Road Traffic Act.
- A statute does not repeal other statutes.
- **Any** point on which the statute leaves a **gap or omission** is **outside its scope**.

The courts have also developed a number of **rules of statutory interpretation**.

Rules of statutory interpretation	
Literal rule	Words should be given their plain, ordinary or literal meaning. Normally a word should be construed in the same literal sense wherever it appears throughout the statute.
Purposive rule	Under this approach to statutory interpretation, the words of a statute are interpreted not only in their ordinary, literal and grammatical sense, but also with reference to the context and purpose of the legislation, ie what is the legislation trying to achieve? This shows how the court took account of the mischief or weakness which the statute was explicitly intended to remedy. In *Gardiner v Sevenoaks RDC 1950,* the purpose of an Act was to provide for the safe storage of film wherever it might be stored on 'premises'. The claimant argued that 'premises' did not include a cave and so the Act had no application to his case. The purpose of the Act was to protect the safety of persons working in all places where film was stored. If film was stored in a cave, the word 'premises' included the cave.
Contextual rule	A word should be construed in its context: it is permissible to look at the statute as a whole to discover the meaning of a word in it.
***Eiusdem generis* rule**	Statutes often list a number of specific things and end the list with more general words. In that case the general words are to be limited in their meaning to other things of the same kind (Latin: *eiusdem generis*) as the specific items which precede them.
***Expressio unius est exclusio alterius* rule**	To express one thing is by implication to exclude anything else. For example, a statutory rule on 'sheep' does not include goats.
***Noscitur a sociis* rule**	A word draws meaning from the other words around it. If a statute mentioned 'children's books, children's toys and clothes' it would be reasonable to assume that 'clothes' meant children's clothes.
***In pari materia* rule**	If the statute forms part of a series which deals with similar subject matter, the court may look to the interpretation of previous statutes on the assumption that Parliament intended the same thing.

7.3.3 Judicial review in common law systems

We noted above that a US citizen has the right to challenge law which appears to be unconstitutional. The role of **determining whether created law conflicts with the Constitution falls to judges**, in the courts, notably the US Supreme Court.

There are two major theories in the US as to how judges should do that. The first is called **originalism**.

Key term

Originalism is the theory that the Constitution should be interpreted according to the original intent of it authors.

The alternative theory is sometimes known as **constructivism**.

Key term

Constructivism is the theory that the Constitution should be interpreted looking beyond the original intent of its authors.

The originalism theory is based in the idea that if judges try and look **beyond** the **original intent** of the authors of the Constitution, they do not have a solid base on which to make a decision. There is greater chance of a decision being made on the grounds of personal or political preference.

However, there are **several problems** with such an approach to interpretation. For example the fact that the drafting process was long and involved many different parties; whose intent should the judges look at? In addition, the method does not account for **change over time**, which is necessary in the context of social development.

The **risk** in any interpretation, but particularly in **constructivism**, going beyond the intent of the authors, is that in effect, nothing acts as a check to the court except its own good judgement.

Question — **Constitutional interpretation**

Is an interpretation of the US constitution by a judge in effect only the application of his personal and political views?

Answer

Given that there is no simple answer to constitutional interpretation, no clear evidence of authors' intentions and that the passage of time leads to new and developing social issues being answered from a Constitutional base, in a way the answer to this is yes, to a degree.

However, a judge's interpretation is not unfettered. He is bound by the way in which the Constitution has been interpreted before and is understood in the legal and historical culture.

Attention!

When we look at **corporate law** later in this Study Text, we shall be looking at the system in the UK as exemplar of other systems adopted around the world. You should bear in mind that this law has been developed in a **common law** system. Hence, although much company law in the UK is **statute** based, and found in the Companies Act 2006, some of it is based in **case law** which has developed over the last 100 and more years.

8 Civil law systems

FAST FORWARD

Civil law systems seek to ensure **comprehensibility** and **certainty** by means of **codification** via **statutes** and **administrative regulations**. In simple terms, so that common law and custom do not apply.

Civil law developed in Continental Europe, during a period of revolutionary change and state forming. We shall use **France** as exemplar.

8.1 Principles of civil law

Two key principles in Civil law are **comprehensibility** and **certainty**. This can be seen in the Codes that provide the hallmark of Civil law, and the different role allocated to judges in the Civil law system compared with the common law systems.

8.2 Codification in civil law

Civil law tradition historically owes much to the **law of the Roman Empire**, and is sometimes given a date of origin as early as 450 BC.

In more recent times, a key period in the development of civil law was the era of **revolution** in Western Europe in the late eighteenth and early nineteenth Centuries. It was after these revolutions that **emerging nations** decided to **codify their law**, abolishing the mixture of common law and custom remaining from Roman times and establish a **national law**.

In France, the process of law-making can been seen in the period after the French Revolution in the years following 1789. The French Civil Code, the **Code Napoleon**, published in 1804 is the key example. France now has a large number of such codes of law. The German Civil Code was published in 1896.

Where law is **codified** in civil law systems, it is generally codified so as to provide a comprehensive code of the enacted law in a certain area. Codes of law are a common feature of civil law, although they are not a compulsory feature. While France has the **Code Napoleon** other civil law countries, such as **South Africa**, do not have codified law.

8.3 Sources of civil law

There are various sources of law in France:

- Constitution
- EU law (again, we shall not consider this in more detail in this chapter)
- Statutes
- Administrative regulations
- Custom (of limited importance, so we shall not consider this further)

The key source of law is **statute**, much of which is **codified**. Administrative regulations are also codified. Statute law is usually **drafted** as **general principles** and in **simple language** as far as possible, so as to ensure that the law is accessible. This is in stark contrast to English statutes, which are complex and drafted to cover many eventualities.

8.4 The role of judges in civil law

FAST FORWARD

In civil law systems, **judges simply apply the law** – they do not make law via judicial precedent, although they may perform **judicial review** to ensure that statutes etc are in line with the **constitution**.

The role of judges in a civil law system is significantly different in theory from the role of a common law judge. In **France**, there is a **distinct division** between those who **draft the law** and those who **apply the law**, judges being the latter.

There is no such thing in France as judge-made law. Hence, while previous decisions of other judges will be **persuasive** to other judges making decisions, they do not create precedent in the same way as in the common law system.

8.4.1 The Court of Cassation

The top court of appeal in France is the **Court of Cassation**. Cassation comes from the French that means 'to quash'. When the Court of Cassation was originally formed, it was a government department set up to quash any court decisions where the legislators felt that the law has been incorrectly interpreted.

The history of the Court of Cassation is therefore not as a court. Originally it was manned not by judges, but by legislators, whose role was to **quash** the original decision and return the case to the court system to be retried.

In practice, the Court became a **court of appeal**, where the people determining that the law had been incorrectly interpreted also set out what the correct interpretation should have been, so that the case was not returned to the judicial system. In time, then, the Court of Cassation has been subsumed into the judicial system.

8.4.2 Statutory interpretation in civil law

There is no general principle in French law on how judges should interpret statute. This is probably due to the historic feeling that judges should not interpret the law but merely apply it to the letter. However, some **general principles** of statutory interpretation have developed.

Statutory interpretation	
'Quand la loi est claire, il faut la suivre'	Where the meaning of the law is clear, it must be followed. French judges will not extend or restrict the scope of a statute that is unambiguous.
'Quand elle est obscure, il faut approfondir les dispositions pour en penetrer l'esprit'	Where the statute is obscure or ambiguous, one should construe it in accordance with the spirit of it, rather than to the letter, in order to determine its legal meaning.
'Si l'en manqué de loi, il faut consulter l'usage ou l'équité'	If there is a gap in the law, judges must resort to custom and equity. However, as we said above, custom is only of limited application in France.

There are also the following alternative methods of statutory interpretation:

- **Teleological method**. This is where a judge seeks to identify the social purpose of the legislation and apply it in a manner that achieves it.
- **Historical method**. This is where the judge looks at the intention of the legislator and then tries to envisage what the intention would be if the law was being drafted in modern times. The judge then applies that intention.

8.4.3 Judicial review in civil law

Although in the Civil law tradition judges do not have a key role interpreting statute, a system of **judicial review** has grown in certain civil law countries. This role is to comment on whether statute law is in accordance with the country's constitution.

This is the case in **Germany**, where **constitutional courts** have been set up for the purpose. However, the judges in constitutional courts are not the same as in the normal court system. In other words, special judges are created to comment on whether legislation in constitutional.

Question — **Codification**

What is the difference between codification in a common law system and codification in a civil law system?

Answer

In civil law systems, codification is understood to be a comprehensive exercise, where ideally all the related law on a subject is incorporated into a code. In common law systems this does not have to be the case, rather codification is the process of putting case law on a statutory basis. The statute is not then necessarily comprehensive of all the law in that area.

Exam focus point

Many of the model laws that we shall look at later in this Study Text are drafted in accordance with civil law principles, so you should remember to note this in any exam question on them.

9 Sharia law systems

FAST FORWARD

Sharia law is based on the religion of Islam. This means that the law extends into **areas of belief and religious practice** and that the **law is god-given** and so has **wider significance than social order**.

The major difference between Sharia law and the other legal systems we have introduced in this chapter is that **Sharia law is explicitly based on**, and connected with, **the religion of Islam**. We shall describe Sharia law in general terms, but also use Pakistan and Iran as exemplar of countries that have adopted Sharia.

Sharia is 'a way to a watering place', in other words, a path to be followed. **Sharia law** is ordained by Allah as guidance for mankind.

9.1 Principle of Sharia law

As can be seen above, the main principle of Sharia law is that it is **the divine way** ordained for man to follow by Allah. The law, therefore, is **sourced directly from Allah** and this has a significant impact on how it is interpreted by judges. In true Sharia tradition, judges are clerics, known as Imam.

9.2 Sources of Sharia law

FAST FORWARD

The main sources of **Sharia** law are the **Quran** and the **Sunnah**. The secondary sources of law are the Madhab.

The **key source of law** in Sharia is the **Quran**, which contains various injunctions of a legal nature.

Key term

The **Quran** is Allah's divine revelation to his Prophet, Muhammad.

The Quran was revealed to the **Prophet Muhammad** during the last years of his life, around 619–632 AD. It was written down piecemeal during his lifetime but not fully collated until after his death.

The Muslim calendar is different from the Western systems of years BC and AD. However, for the purposes of comparability with common and civil law systems, the AD dates are being used here.

The Quran includes various injunctions of a legal nature, but it does not cover every detail, so **another primary source of law** in Sharia is the **Sunnah**.

Key terms

The **Sunnah** is 'the beaten track', in other words, what has come to be the acceptable course of conduct. It is derived from the sayings of the Prophet, known as **Ahadith** (known in singular as Hadith).

There are also five **major secondary sources** of law in the Muslim world, known as **Madhab**. These are schools of thought based on **writings and thoughts of major jurists** formed in the years immediately following the death of the Prophet and are named after those jurists:

- The Shia school
- The Hanafi school (Imam Abu Hanifa)
- The Maliki school (Imam Malik)
- The Hanbali school (Imam Ahmad Ibn Hanbal)
- The Shafii school (Imam As-Shafii)

These schools of law are given more prominence in certain parts of the world, so, for example, parts of Iraq and parts of **Iran** follow the Shia school ('Shia Muslims'). The majority of the Muslim world follows the other four schools, which together, are termed Sunni (hence 'Sunni Muslims'). In **Pakistan**, the generally preferred school is Hanafi.

9.2.1 Constitution

Many Muslim countries have a written constitution. Both the countries we are using as exemplar of the system, Iran and Pakistan, have such a constitution. The Iranian Constitution upholds the role of Sharia law in Iran, as can be seen from Article 2 of the Constitution.

Case Study

Iranian Constitution, Article 2

The Islamic Republic is a system based on belief in:

1 The One God (as stated in the phrase 'There is no god except Allah'), His exclusive sovereignty and the right to legislate, and the necessity of submission to His commands

2 Divine revelation and its fundamental role in setting forth the laws

3 The return to God in the Hereafter, and the constructive role of this belief in the course of man's ascent towards God

4 The justice of God in creation and legislation

5 Continuous leadership (imamah) and perpetual guidance, and its fundamental role in ensuring the uninterrupted process of the revolution of Islam

6 The exalted dignity and value of man, and his freedom coupled with responsibility before God; in which equity, justice, political, economic, social, and cultural independence, and national solidarity are secured by recourse to:

- Continuous ijtihad of the fuqaha' possessing necessary qualifications, exercised on the basis of the Qur'an and the Sunnah of the Ma'sumun, upon all of whom be peace
- Sciences and arts and the most advanced results of human experience, together with the effort to advance them further
- Negation of all forms of oppression, both the infliction of and the submission to it, and of dominance, both its imposition and its acceptance.

We shall discuss the process of **ijtihad** later in this section.

9.3 The role of judges in Sharia law

FAST FORWARD

In Sharia law, judges may need to **interpret** the law (it cannot be changed). They do this in line with the **Sunnah Ahadith** (sayings of the Prophet) that are varyingly reliable. **Figh** is the process of further legal interpretation, using **ijtihad**. Judges may also perform a form of judicial review.

As we have observed above, the **religious nature** of Sharia means that in true Sharia tradition, **judges are clerics**, known as Imam. This is the situation in **Iran**, for example. However, in other Muslim states, there are a **mixture of clerical judges and secular judges**.

Judges are required to apply the law to cases brought before them. However, given the **nature and source** of the law, there are **particular considerations** with regard to **interpretation** of the law.

9.3.1 Interpretation of Sharia law

The **Quran cannot be altered**, being the Word of Allah. It may only be **interpreted**. This leads to the problem in Islamic circles of who is **qualified to interpret** the Quran. Muhammad, as Allah's prophet, was qualified to do so.

When clear guidance cannot be obtained from the Quran, the judge may turn to the **Sunnah** to see **how the Quran was interpreted by the Prophet**. The Sunnah is used by Muslim jurists to:

- **Confirm** the law in the Quran
- **Explain** matters mentioned in the Quran in general terms
- **Clarify** verses in the Quran that may seem ambiguous
- **Introduce** a rule where the Quran is silent

The **Ahadith** that comprise the Sunnah were recorded some time after the death of the Prophet and are **classified according to reliability**. Some are **virtually guaranteed**, and are known as **muwatir**. Others are **less certain** and known as **mashtur**. Lastly, where there is **little certainty** as to their authenticity, Ahadith are called **ahad**.

9.3.2 Schools of Sharia law

There is **controversy** in the Muslim world as to **whether matters of legal and religious significance should be interpreted further**, or whether everything is clear and new cases should not bring the need for further development of the law. Those that believe more development is needed developed a science of understanding and interpreting legal rules, known as fiqh, through the techniques of ijtihad (see below).

The theory that no more interpretation is needed is known as **Taqlid**, which is the process strict adherence to established doctrine. Orthodox Muslims would adhere to Taqlid, although some would claim there was a need to deal pragmatically with the results of new, Western influences in their countries.

Taqlid was the result of what is known as '**closing the gates of Ijtihad**' which took place during the course of the sixteenth to nineteenth Centuries AD.

Key term

Ijtihad are the processes for ascertaining the law. It is the use of intellectual exertion by a jurist to derive an answer to a legal question.

The basis for Ijtihad is a **Hadith** which records that the Prophet approved an Imam who told him that in making a judgement, he would rely first on the Quran, then on the Sunnah, and then he would exert his own judgement.

There are various rules associated with exercising an ijtihad:

- It **must not be exercised on certain matters** (for example, the existence of Allah)
- The judge must be **suitably qualified**, known as a **muhtahid**
- There are various **recognised methods**

In order to **qualify** as a muhtahid a person must be:

- **Well versed** in the **study** of the **Quran**
- **Well versed** in the **traditions** of the **Prophet**
- **Understand** the **principle** of **ijma'** (see below)
- **Understand** the **conditions** for **qiyas** (see below)
- A **good** and **practising Muslim**
- **Just**, **reliable** and **trustworthy**

One reason there is controversy about whether interpretation should still take place is that many people believe that these **qualification criteria** are **too difficult** to meet in modern times, given the time lapse since the death of the Prophet.

Two of the recognised methods for exercising Ijtihad have been mentioned in these **qualification criteria**. The full list of methods is:

- Ijma'
- Qiyas
- Istihsan
- Maslahah mursalah
- 'Urf
- Istishab

The first three are **key methods**. Maslahah mursalah means something very similar to Istihsan (see below). 'Urf is the theory that local custom may be subsumed into the law if it is not contrary to Sharia.

Istishab is a **legal presumption** that the current state of affairs continues until the contrary is proved. Something is permitted until it is shown that it is forbidden.

Key terms

Ijma' is a consensus of opinion. It should be based on consultation between jurists.

Qiyas is analogical deduction. In other words, it is a comparison of two things with a view to evaluating one in the light of the other.

An example of qiyas is to say that taking drugs is forbidden, on the basis that the Quran states that alcohol is forbidden, and the effects of taking drugs are similar to the effects of taking alcohol.

Key term

Istihsan is the concept of equity, or of fairness. However, in Sharia, the exercise of equity is clearly only permissible within the bounds of the Sharia as it is integral to the system.

9.3.3 Judicial review in Sharia law

In some Muslim states, the State will issue statutes, although these should be based on Sharia law principles. In addition, since wholesale adoption of Sharia by Islamic nations is a fairly recent trend, they may have enacted law from before adoption. The Hudood Ordinances in Pakistan from the 1970s set out in statute the Sharia law relating to criminal law.

Pakistan has a **Federal Shariat Court** which has a key role in judicial review. One of its objectives is to determine whether a provision of (statute) law is repugnant to the injunctions of Islam.

Another aspect of the Federal Shariat Court's role is to hear appeals under the Hudood rules.

9.4 The rule against usury

A rule in Sharia law that has a significant impact on commerce and trade is the rule against usury, known in Sharia as **riba**.

Key term

Riba is the Islamic concept of unlawful gain, usually translated as interest, which is strictly forbidden by the Quran.

In theory, riba, 'unlawful gain' translates to be **qualitative inequality** and is a highly technical area. For our purposes, and **in practice**, it is often seen as a **rule against charging or receiving interest**.

Attention!

We shall see later in this Study Text how this impacts Muslim commerce.

The concept of riba also has a significant impact on the way that Muslims bank, which you should be aware of, although we shall not look at the details of Muslim banking in this Study Text.

Question — **Statutory interpretation**

Compare and contrast Common, Civil and Sharia law methods of interpreting law.

Answer

The key issue to bear in mind when considering statutory interpretation is that Civil law judges are not entitled to interpret the law but merely to apply it. In Sharia law whether judges are entitled to interpret the law is also a controversial subject. These systems both contrast with Common law systems where a key role of the judge is to interpret the law in applying it to a set of facts.

However, in practice in all systems, in order to apply the law, some interpretation will sometimes be necessary. In each system, therefore, there is a set of principles relating to how the law will be interpreted.

In Common law, judges both form and apply the law. However, when deciding a case based on statute law, judges will have to interpret those statutes, and in the UK a number of presumptions and rules have been developed to help them do so.

The major presumptions are that statute does not alter the existing Common law, it does not have retrospective effect, it does not bind the Crown, it does not intend to deprive a person of his liberty and if it does deprive a person of his property he is to be compensated. A statute is only valid in the UK, it cannot impose criminal liability without proof of guilt, it does not repeal other statutes unless it says so and if it contains gaps and omissions, excluded matters are outside the scope of the law.

The Common law also has a number of rules designed to assist interpretation. These include, the literal rule (words must be given their literal meaning), the golden rule (the statute cannot contradict itself of be manifestly absurd) and the mischief rule (the statute should be interpreted so as to eliminate the mischief it was designed to eliminate).

In Civil law judges are dissuaded from interpreting statute as a general rule. However, this is not always possible, and the following rules of interpretation have been developed in France:

- Where the meaning of the law is clear it must be followed.
- Where the law is ambiguous, the spirit of it should be followed
- Where the law is silent (rare), the judge should resort to custom or equity

In addition to these general principles, a judge in France may choose to enforce the social purpose of the law, or look to what the legislator's intent was, and try and apply that to a modern situation.

The desire to follow the spirit of the law when there is ambiguity is similar to the Common law mischief rule.

In Sharia law, law is Allah-given and in principle should not be interpreted. The rule of Taqlid states that the law should not be interpreted further and that law should be decided on the basis of existing principles. However, some countries follow the principles of Ijtihad, the process of ascertaining the law. For example, Iran's constitution refers to Ijtihad in Article 2.

There are various recognised methods of exercising Ijtihad. The key methods are:

- Ijma'
- Qiyas
- Istihsan

Ijma' is the consensus of opinion of jurists. In higher courts in Common and Civil law systems, often more than one judge will sit together to make decisions, so this principle is comparable to those systems. However, Common law judges reach decisions by a majority, not a consensus, so this is not strictly the same.

Qiyas is the process of analogical deduction, or comparing one thing to another (for example, drinking alcohol and taking drugs). This can be contrasted to Common law and Civil law principles where generally speaking, if a matter is excluded from the law, judges should not add it in to the law.

Istihsan is the concept of equity, which exists in the context of both Common and Civil law, although the exercise of equity within the boundaries of the different systems would be likely to bring different results.

The key difference between interpretation in Sharia law and the other two legal systems is that in Sharia law, the law is given by God and is therefore historic and fixed, whereas Common and Civil law is constantly developing and being produced by men. New laws will require new interpretations, whereas where the law is fixed, in Sharia tradition the theory of Taqlid states that it has been interpreted sufficiently to meet every legal situation.

Chapter Roundup

- There are some **model international laws** that regulate the relationship of sovereign states, and their rights and duties with respect to each other. Most law, however, consists of **national laws**, which nevertheless follow certain **common methodologies**.
- There are **three key legal systems** or **underlying methodologies of law** operating in the world that have been adopted by different countries for different reasons: common law, civil law and Sharia law.
- Economics can be described as the ways in which society decides **what to produce**, **how to produce it** and **who to produce it for**. There are three basic kinds of economic system – planned, market and mixed economies.
- **Political systems affect legal systems**. There may be a **democracy** or a **dictatorship**, which generally influences the **nature of the rule of law** in the nation. In democratic systems there is usually **separation of powers** between the head of state, the executive, the legislature and the judiciary. In dictatorial systems some or all of these powers may be combined so that one person or party has total power.
- 'Legal systems' can be used in **two** senses: to describe the body of laws and mechanisms for their enforcement in a country, and to describe the underlying nature of a country's law.
- **Law** is the enforceable body of rules that govern any society. **Positive law** is the body of law imposed by the state.
- The main distinctions to be made between types of law are between **national** and **international** law, and between **criminal** and **civil** law.
- **Conflict of laws** occur when people from different legal jurisdictions trade with each other and their respective legal rules conflict. **International law** is the system of law regulating the interrelationship of sovereign states and their rights and duties with regard to one another.
- Sources of international law are **public** (treaties, custom and general legal principle) and **private** (a nation's own national laws which regulate international dealings).
- A **crime** is conduct prohibited by the law. It is usually **punished** by the State, which **prosecutes** the case, by means of **fines** or **imprisonment**. There is usually a **heavy burden of proof**.
- **Civil law** exists to regulate disputes about the rights and obligations of persons when dealing with each other. The State is not party to a civil case, and there is a lighter burden of proof.
- **Common law builds up over time**, added to by the legislature (statutes are presumed to add to, not alter, existing law) and by **judicial precedent**.
- Judges play two roles in building up **case law** in common law systems – by setting and applying **judicial precedent**, and, by **interpreting statutes**, they also perform the important function of **judicial review**.
- Civil law systems seek to ensure **comprehensibility** and **certainty** by means of **codification** via **statutes** and **administrative regulations**. In simple terms, so that common law and custom do not apply.
- In civil law systems, **judges simply apply the law** – they do not make law via judicial precedent, although they may perform **judicial review** to ensure that statutes etc are in line with the **constitution**.
- Sharia law is based on the religion of Islam. This means that the law extends into **areas of belief and religious practice** and that the **law is god-given** and so has **wider significance than social order**.
- The main sources of **Sharia** law are the **Quran** and the **Sunnah**. The secondary sources of law are the Madhab.
- In Sharia law, judges may need to **interpret** the law (it cannot be changed). They do this in line with the **Sunnah Ahadith** (sayings of the Prophet) that are varyingly reliable. **Figh** is the process of further legal interpretation, using **ijtihad**. Judges may also perform a form of judicial review.

Quick Quiz

1 **Fill in the blanks.**

……… is the ………………. ……… of …… that govern any society.

2 What is the standard of proof in civil proceedings?

3 What is Istihsan?

4 Principles of English law do not become inoperative through lapse of time.

True ☐

False ☐

5 Statute law is:

A Law made in Parliament
B Law made by judges
C Law found in the Quran
D Law established by a country's Constitution

6 The four rules associated with applying a judicial precedent are:

(1) ....

(2) ....

(3) ....

(4) ....

7 **Fill in the blanks.**

In the civil law tradition, ... is the process of putting .... the law on a specific area together in a ....

8 French law is usually drafted as general principles and in simple language to ensure that the law is accessible.

True ☐

False ☐

9 Which of the following is the Sunnah not used to do?

A Confirm the law in the Quran
B Introduce a rule on a topic set out in the Quran
C Clarify matters in the Quran that may seem ambiguous
D Explain matters mentioned in the Quran in general terms

10 What is riba?

Answers to Quick Quiz

1 **Law** is the **enforceable body** of **rules** that govern any society.

2 The case must be proved on the balance of probability.

3 **Istihsan** is the concept of equity or fairness in Islamic law.

4 True. They do not become inoperative due to age.

5 A. Law made in Parliament

6 (1) A precedent must be based on a decision of law, not of fact

(2) It must form part of the *ratio decidendi* of the case

(3) The material facts of each case must be the same

(4) The preceding court must have had a superior status to the court using the precedent

7 In the civil law tradition, **codification** is the process of putting **all** the law on a specific area together in a **code**.

8 True. Simple language is used so all members of the public can understand it.

9 B. The Sunnah must not add law on a matter mentioned in the Quran. This is only permitted where the Quran is silent on an issue.

10 Riba is qualitative inequity, or unlawful gain, usually translated as the giving or receiving of interest.

Now try the question below from the Exam Question Bank

Number	Level	Marks	Time
Q1	Examination	10	18 mins

2

International trade and regulation

Topic list	Syllabus reference
1 Public and private international law	A3(a)
2 Conflict of laws and the need for international regulation	A3(b), A3(c)
3 Role of international organisations in trade	A3(d)
4 Court-based adjudication	A3(d), A4(a)
5 Alternative dispute resolution (ADR)	A4(a)
6 Role of international courts in trade	A3(d), A4(a)

Introduction

In the last chapter, we made reference to **international law**, and began to suggest why its development has been considered necessary. This is basically because of the problem of **conflict of laws**.

In this chapter, we shall look specifically at the acts and events which increasingly give rise for **international co-operation** in the area of law. Although we shall consider acts of international significance, such as war crimes and abuses of human rights, the issue of major significance for our syllabus is **international trade and commerce**. We shall begin to look at the issues surrounding this.

The need for international regulation has been recognised by a number of **international bodies** in various ways. We shall introduce some of these bodies and in general terms, discuss their history and their aims. Some have been active in producing model laws and codes that we shall be looking at later in the Study Text.

Lastly in this chapter we shall consider some of the international institutions which exist to **adjudicate international legal disputes**.

Study guide

		Intellectual level
A3	**International trade, international legal regulation and conflict of laws**	
(a)	Explain the distinction between public international law and private international law	1
(b)	Explain the need for international legal regulation in the context of conflict of laws	2
(c)	Explain the function of international treaties, conventions and model codes	2
(d)	Explain the roles of international organisations, UN, ICC, WTO, COE, OECD, UNIDROIT, etc and courts in the promotion and regulation of international trade	1
A4	**Alternative dispute resolution mechanisms**	
(a)	Explain the operation and evaluate the distinct merits of court-based adjudication and Alternative Dispute Resolution Mechanisms	2

Exam guide

Questions on these topics are most likely to be knowledge questions, focusing on the role of the different bodies involved in the operation and development of international law, and on the features of international commerce that make such development necessary.

1 Public and private international law

FAST FORWARD

Public international law governs the relations between states and international organisations. **Private international law** regulates cases where there is a conflict of laws.

We saw in Chapter 1 that international law is the system regulating the interrelationship of sovereign states and their rights and duties with regard to one another. We need to break international law down further.

(a) **Public international law** consists of rules and principles which apply in general to the conduct of sovereign states and international organisations and the relationships between them.

(b) **Private international law** regulates cases which involve the national laws of two or more states where a different result will ensue depending on which state's law is applied.

2 Conflict of laws and the need for international regulation

Public international law is to do with the **recognition of states**, or **wars**, or the aftermath of wars, that is events which are considered of **international significance**. Part of international law is therefore dealing with matters such as **war crimes** and other **human rights abuses**.

However, our syllabus is only concerned with situations where individuals or corporations interact or act on the basis of international commerce, that is **private international law**.

As we began to explore in Chapter 1, economics, politics and law all affect **international** trade. Given the differences between economic and political systems in nations, there are therefore significant barriers to free international trade.

2.1 Barriers to free international trade

FAST FORWARD

Barriers to free trade exist to **protect** markets from outside competition. They include: tariffs or customs duties; import quotas; embargoes; hidden subsidies for exporters and domestic producers; import restrictions, as well as the barriers created by differences in laws.

In practice many barriers to free trade exist because governments try to protect home industries against foreign competition. **Protectionism** can be practised by a government in several ways.

2.1.1 Tariffs or customs duties

Tariffs or customs duties are taxes on **imported goods**. The effect of a tariff is to raise the price paid for the imported goods by domestic consumers, while leaving the price paid to foreign producers the same, or even lower. The difference is transferred to the government sector.

2.1.2 Import quotas

Import quotas are restrictions on the **quantity** of a product that is allowed to be imported into the country. The quota has a similar effect on consumer welfare to that of import tariffs, but the overall effects are more complicated.

- Both domestic and foreign suppliers enjoy a higher price, while consumers buy less at the higher price.
- Domestic producers supply more.
- There are fewer imports (in volume).
- The government collects no revenue.

2.1.3 Embargo

An **embargo** on imports from one particular country is a total ban, ie effectively a zero quota.

2.1.4 Hidden export subsidies and import restrictions

There has been an enormous range of government subsidies and assistance for exports and deterrents against imports. Some examples are given below.

- **For exports** – export credit guarantees (insurance against bad debts for overseas sales), financial help (such as government grants to the aircraft or shipbuilding industry) and general state assistance
- **For imports** – complex import regulations and documentation, or special safety standards demanded from imported goods and so on.

2.1.5 Differences in law

In addition to the economic problems above, there are legal barriers to trading between nations. For instance, take a moment to try and define what a contract is. A contract is something **defined by the law**, and so, as the law varies from country to country, may be one thing in one country and a different thing in the other. It may have different legal consequences in different parts of the world.

For example, the following definition of contract could be given.

Key term

A **contract** is a legally binding agreement.

However, **what makes an agreement legally binding** is **likely to vary** from country to country. In one country, a legally binding agreement may be formed by two people making an agreement and shaking hands on it. In another, the agreement may have to be committed to writing and evidenced by witnesses.

In some countries, it may be the case that an agreement does not become legally binding unless **other conditions** are fulfilled. For example, in England, there is a legal doctrine known as consideration. Under this doctrine parties have to exchange promises, acts or forfeitures of value to create a contract. Such a legal doctrine is unknown in other parts of the world.

This raises a problem. People wanting to engage in international trade, say A (from country Z) wants to trade with B (from country Y). If the relationship breaks down, the following issues could arise:

- A could claim that under Z's law, no contract was ever formed.
- B could claim that under Y's law, no contract was ever formed.
- Both parties could claim that the contract is not legally enforceable in their country.
- The remedies available for broken contracts in the different countries may differ.
- The parties might disagree on which country to seek legal resolution in.
- They might seek legal resolutions in their countries and be unable to enforce them.

The list above summarises some of the issues arising from **conflict of laws**, which we saw briefly in Chapter 1.

2.2 Conflict of laws

FAST FORWARD

Conflict of laws is where parties from different nations have a legal dispute, and it is necessary to determine which national law governs the validity of the legal situation.

2.2.1 Example: Conflict of laws

A contract is made in England, but the contract is to be fulfilled in India. The relationship between the parties breaks down and legal resolution is sought. But should this be under English law or Indian law?

2.2.2 International conventions, treaties and model laws

When problems such as the above arise, **international co-operation** is required to ensure that solutions can be found. Otherwise, the parties may be able to avoid each other and any solutions sought may not be enforceable.

Countries have sought solutions to these problems by coming to **agreements** with each other and by enacting various **conventions** and **treaties** that **regulate international practice**. UN Conventions are binding under international law on states and other entities.

For instance, the **Rome Convention 1980** set out policy on what law should govern the validity of international contracts. It sets down the general principle that if the parties have a **written contract** and have **expressed preference** for a particular law in that written contract, that law should govern the contract. This is known as **choice of laws**.

The **New York Convention 1958** set out the agreement of countries relating to referring cases to arbitration.

However, the conventions have not necessarily solved all the problems presented by conflict of laws completely. The United Nations (see below) has also developed **model laws** that countries may adopt into their own national laws. These make practices uniform on an international basis and iron out any remaining problems.

Attention!

Later in the Study Text we shall look in detail at the UN's Model Laws on arbitration, credit transfer, insolvency and agency. We shall also see the Conventions on sale of goods and bills of exchange.

3 Role of international organisations in trade

FAST FORWARD

Important bodies associated with international law include the EU, the UN, the ICC, the WTO, the COE, the OECD and UNIDROIT.

Case Study

The European Union (EU)

The European Union (EU) is one of several international economic associations. It was formed in 1957 by the Treaty of Rome and now consists of 27 European nations, including a number of Eastern European countries which were formerly operated as centralised planned economies under Communist regimes.

The European Union has a **common market** combining different aspects, including **a free trade area** and a **customs union**.

(a) A **free trade area** exists when there is no restriction on the movement of goods and services between countries. This may be extended into a **customs union** when there is a free trade area between all member countries of the union. In addition, there are common external tariffs applying to imports from non-member countries into any part of the union. In other words, the union promotes free trade among its members but acts as a protectionist bloc against the rest of the world.

(b) A **common market** encompasses the idea of a customs union but has a number of additional features. In addition to free trade among member countries there are also free markets in each of the **factors of production**. For example, a British citizen has the freedom to work in any other country of the European Union. A common market will also aim to achieve stronger links between member countries, for example by harmonising government economic policies and by establishing a closer political confederation.

The Single European Market

The EU set the end of 1992 as the target date for the removal of all existing physical, technical and fiscal barriers among member states. This created a large multinational European Single Market and was embodied in the Single European Act of 1985. In practice, these changes have not occurred overnight, and many of them are still in progress.

Elimination of trade restrictions covers the following areas.

(a) **Physical barriers** (eg customs inspection) on goods and services have been removed for most products. Companies have had to adjust to a new VAT regime as a consequence.

(b) **Technical standards** (eg for quality and safety) should be harmonised.

(c) Governments should not discriminate between EU companies in awarding **public works contracts**.

(d) **Telecommunications** should be subject to greater competition.

(e) It should be possible to provide **financial services** in any country.

(f) There should be **free movement of capital** within the community.

(g) **Professional qualifications** awarded in one member state should be recognised in the others.

(h) The EU is taking a co-ordinated stand on matters related to **consumer protection.**

At the same time, you should not assume that there will be a completely 'level playing field'. There are many areas where harmonisation is a long way from being achieved. Here are some examples.

(a) **Company taxation**. Tax rates, which can affect the viability of investment plans, vary from country to country within the EU.

(b) **Indirect taxation** (eg Value Added Tax or VAT). While there have been moves to harmonisation, there are still differences between rates imposed by member states.

(c) **Differences in prosperity**. There are considerable differences in prosperity between the wealthiest and the poorest EU economies.

(d) **Differences in workforce skills**. Again, this can have a significant effect on investment decisions. The workforce in Germany is perhaps the most highly trained, but also the most highly paid, and so might be suitable for products of a high added value.

(e) **Infrastructure**. Some countries are better provided with road and rail than others. Where accessibility to a market is an important issue, infrastructure can mean significant variations in distribution costs.

Internationalising legal practices in relation to trade has taken the co-operation of nations. This has been advanced by various international organisations which we shall introduce.

3.1 The United Nations (UN)

Almost every independent state in the world is a member of the **United Nations (UN)**. The UN started in 1945 when the then members ratified the UN charter. The purposes of the UN are to:

- Maintain peace and security
- Develop friendly relations among nations
- Co-operate in solving economic, social, cultural and humanitarian problems
- Promote respect for human rights and international freedoms

The UN has various organs, one of which is the **International Court of Justice**, which we shall look at in more detail later.

The UN Charter states that member nations should **develop and codify international law**. Currently, there are over 500 UN conventions, treaties and standards which legally bind the States that ratify them.

There are two bodies in the UN involved in drafting international law. These are:

- International Law Commission
- UN Commission on International Trade Law (UNCITRAL)

Attention!

We shall be looking at international trade law, in Part B of this Study Text.

3.2 UN Commission on International Trade Law (UNCITRAL)

UNCITRAL is the core legal body within the United Nation's in the field of international trade law. It was established in 1966, when the General Assembly recognised that disparities in national laws governing international trade created obstacles to the flow of trade. UNCITRAL was given the task of harmonising and unifying the law of international trade by:

- **Co-ordinating** the work of organisations active in the field and encouraging co-operation among them.
- **Promoting** wider participation in **existing international conventions** and **wider acceptance** of existing model and uniform laws.
- **Preparing** or promoting the adoption of **new international conventions**, **model laws** and **uniform laws**. The promotion of, codification and wider acceptance of international trade terms, provisions, customs and practices, in collaboration, where appropriate, with the organisations operating in this field.
- **Promoting** ways and means of ensuring a **uniform interpretation** and **application** of international conventions and uniform laws in the field of international trade.

- **Collecting** and **disseminating information** on national legislation and modern legal developments, including case law, in the field of international trade law.
- **Establishing** and **maintaining a close collaboration** with the United Nations Conference on Trade and Development.
- **Maintaining liaison** with other **UN organs** and **specialised agencies** concerned with international trade.
- **Taking any other action** it may deem useful to fulfil its functions.

A total of 60 member States are elected by the UN General Assembly to form UNCITRAL. It is structured so as to be **representative** of the world's various geographic regions, economic and legal systems. The Commission carries out its work at annual sessions, held in alternate years at United Nations Headquarters in New York and in Vienna. Members of the Commission are elected for terms of six years; half the members' terms expire every thee years.

The Commission operates through **six working groups**, composed of all member States of the Commission. The six working groups and their current topics are as follows:

- Working group I – Privately financed infrastructure projects
- Working group II – International arbitration and conciliation
- Working group III – Transport law
- Working group IV – Electronic
- Working group V – Insolvency
- Working group VI – Security interests

Non-members of the Commission and other interested international organisations are invited to attend sessions of the Commission and of its working groups as **observers**. They can participate in any discussions to the same extent as members.

UNCITRAL has achieved the following outcomes, among others:

- *UN Convention on Contracts for the International Sale of Goods.* This Convention established a comprehensive code of legal rules governing the formation of contracts for the international sale of goods. This includes, the obligations of the buyer and seller, remedies for breach of contract and other aspects of the contract. We shall see it in detail in Part B of this Text.
- *UN Convention on the Carriage of Goods by Sea* (The Hamburg rules). This Convention established a uniform legal regime governing the rights and obligations of shippers, carriers and consignees under a contract of carriage of goods by sea.
- *UN Convention on International Bills of Exchange and International Promissory Notes.* This Convention provides a comprehensive code of legal rules governing international instruments for use in international commercial transactions. We shall see this in Chapter 6 of this Text.
- *UNCITRAL Model Law on International Commercial Arbitration.* These provisions are designed to assist States in reforming and modernising their laws on arbitral procedure so as to take into account the particular features and needs of international commercial arbitration. We shall see this later in this chapter.
- *UNCITRAL Model Law on Electronic Commerce.* This Model Law, adopted in 1996, is intended to facilitate the use of modern means of communications and storage of information.
- *UNCITRAL Model Law on Cross-Border Insolvency.* This Model Law seeks to promote fair legislation for cases where an insolvent debtor has assets in more than one State.

3.3 International Chamber of Commerce (ICC)

The **International Chamber of Commerce (ICC)** was formed in 1919 'to serve world business by promoting trade and investment, open markets for goods and services, and the free flow of capital'.

It was originally created by business leaders from Belgium, UK, France, Italy and the United States. Now it is a **world wide** business organisation with thousands of member companies and associations from 130 countries.

The ICC makes representations to governments on issues related to **international trade**. It also develops **codes of practice** to encourage businesses to operate with a minimum of government intervention. The ICC co-operates with and advises the **United Nations** and provides **practical services to businesses** and seeks to **combat commercial crime**.

For our purposes, an important aspect of the ICC is that it set up the **International Court of Arbitration** in 1923, which we shall look at later in this chapter.

3.4 World Trade Organisation (WTO)

The **World Trade Organisation (WTO)** is the newest of the various international organisations we are looking at. It was formed in 1995 as successor to the General Agreement on Tariffs and Trade (GATT) which was set up after World War II. It is an organisation that devotes itself entirely to international trade in goods, services, traded inventions, creations and intellectual property.

The WTO has nearly 150 members and these represent 97% of international trade. The organisation seeks to **promote the free flow of trade** by removing obstacles to trade, and to make sure that individuals, companies and governments know what these rules are. The WTO:

- Administers trade agreements
- Is a forum for trade agreements
- Settles trade disputes
- Reviews national trade policies
- Assists developing countries in trade policy issues (training/technical assistance)
- Co-operates with other international organisations

GATT is the WTO's main **guidelines on international trade** in goods. It is the result of negotiations between nations and is subject to updating and revision. For example, when the WTO was set up and GATT was extended to **intellectual property**, **services**, **dispute settlement** and other areas.

The WTO Agreements contain the principles of **liberalisation** of **free trade**. They include commitments by each country to lower customs tariffs and other trade barriers, and to open and keep open services markets. They also set procedures for settling disputes.

The current set of agreements is the outcome of the 1986-94 Uruguay Round GATT negotiations which set up a non-discriminatory trading system that spells out each country's **rights** and **obligations**. Each country receives guarantees that its exports will be treated fairly and consistently in members' markets and promises to do the same for imports into its own market. There is some latitude towards 'developing' countries in how they implement their commitments. There are limited permitted exceptions negotiated on a country by country basis.

All WTO members must **notify** the WTO about laws in force and measures adopted. They must undergo periodic scrutiny, each review containing reports by the country concerned and the WTO Secretariat.

Decisions of the WTO are made by the **entire membership**, usually on the basis of consensus. The structure of the WTO is as follows.

(a) The *Secretariat* is based in Geneva, with around 600 staff under a director-general. The Secretariat's role is to supply technical support for the various councils and committees and the ministerial conferences. It also provides technical assistance for developing countries, to analyse world trade, to explain WTO affairs to the public and media and provide some form of legal assistance in the dispute settlement process.

(b) The *Ministerial Conference* is the WTO's top level decision-making body, meeting at least once every two years.

(c) The *General Council* meets several times a year in Geneva, sometimes as the Trade Policy Review Body and the Dispute Settlement Body.

(d) Special councils such as the Goods Council, Services Council and Intellectual Property (TRIPS) Council report to the General Council.

(e) Committees, *working groups* and *working parties* deal with the individual agreements and other areas such as the environment, development, membership applications and regional trade agreements.

Via the Dispute Settlement Body (DSB) the WTO operates a dispute settlement procedure for resolving trade quarrels between member countries. If this proves unsuccessful, the parties engage in a stage-by-stage procedure that may eventually result in a binding ruling by a **panel of experts** appointed by the Body of in each dispute, subject to an **appeal**. The panel's judgements are based on interpretations of the agreements and individual countries' commitments.

The **Dispute Settlement Body** can accept or reject the panel's findings or the results of an appeal on a point of law only. It monitors how the rulings and recommendations are implemented, and it can authorise retaliation when a country does not comply with a ruling.

The **panel of experts** is appointed by the DSB in consultation with the countries in dispute. Only if the two sides cannot agree does the WTO director-general appoint them. Panels consist of three (possibly five) experts from different countries, who examine the evidence and decide who is right and who is wrong. The panel's report is passed to the Dispute Settlement Body, which can only reject the report by consensus. Panelists for each case are chosen from a permanent list of well-qualified candidates, or from elsewhere, but they serve in their individual capacities and cannot receive instructions from any government.

Any **appeal** is heard by three members of a permanent seven-member Appellate Body set up by the Dispute Settlement Body and broadly representing the range of WTO membership. Members of the Appellate Body have to be individuals with recognised standing in the field of law and international trade, and must not be affiliated with any government. The appeal can uphold, modify or reverse the panel's legal findings and conclusion but the final decision rests with the Dispute Settlement Body, which has to accept or reject the appeals report within 30 days. Rejection is only possible by consensus.

3.5 Council of Europe (CoE)

The **Council of Europe (CoE)** is an organisation which aims to:

- Protect human rights, pluralist democracy and the rule of law
- Promote awareness and encourage the development of **Europe's cultural identity** and **diversity**
- Seek **solutions to problems facing European society** (discrimination against minorities, xenophobia, intolerance, environmental protection, human cloning, AIDS, drugs, organised crime etc)
- Help **consolidate democratic stability in Europe** by backing political, legislative, and constitutional reform

Any European state may become a member of the CoE.

Exam focus point

In an exam question you should not confuse the European Union (EU) with the Council of Europe. Although many European states are members of both, they are entirely separate organisations.

The CoE works towards **legal cooperation** in Europe, by seeking to harmonise national legislation, improving judicial procedures and seeking common solutions to modern legal problems.

The CoE produces **Conventions** which, when adopted by states, are legally binding, and issues **recommendations**, which act as guidelines for the states to use. The CoE has issued conventions relating to, among others, extradition, confiscation of the proceeds of crime, protection of wildlife and natural habitats, doping in sport, bioethics and cloning, nationality, and corruption.

3.6 Organisation for Economic Cooperation and Development (OECD)

The **Organisation for Economic Cooperation and Development (OECD)** is a **group of member countries**. It originally comprised countries in North American and Europe but has expanded to include such countries as Japan, Australia, Mexico and Korea. **It has members from most of the continents**.

The OECD developed in 1961 out of an organisation set up to administer American and Canadian aid to Europe after World War II.

Its purpose is to be 'a forum to **discuss, develop and refine economic and social policies**'. It has created both **legally binding agreements** (for instance in relation to bribery) and also **non-binding agreements** (such as guidelines for multinational enterprises).

The OECD invites non-member countries to subscribe to its agreements as well as members, and is involved in a further 70 countries, including China, Russia, Brazil and some countries in Africa.

3.7 International Institute for the Unification of Private Law (UNIDROIT)

The International Institute for the Unification of Private Law (UNIDROIT) is an **independent intergovernmental organisation** which studies the need for and how to modernise, harmonise and co-ordinate private international law, and in particular trade law. It is based in Rome and has operated since 1926.

Membership of UNIDROIT is restricted to 61 states which have signed up to the UNIDROIT Statute. They represent all five continents and a variety of different legal, economic and political systems.

UNIDROIT is structured as follows:

(a) The **Secretariat** is responsible for the day-to-day running of UNIDROIT's work programme. There is a Secretary-General plus a staff of international civil servants and various ancillary staff.

(b) The **Governing Council** supervises UNIDROIT's policy. It draws up the work programme and supervises how the Secretariat is carrying it out. It comprises the President of the Institute and 25 elected members, typically eminent judges, practitioners, academics and civil servants.

(c) The **General Assembly** is the ultimate decision-making organ of UNIDROIT, approving the annual budget, approving the work programme and electing the Governing Council. Each member Government has one representative.

UNIDROIT's basic objective is to prepare modern, harmonised and uniform rules of **private international law**. Sometimes it strays into public international law, especially in areas where hard and fast lines of demarcation are difficult to draw or where the laws are very complicated and interlinked. Uniform rules prepared by UNIDROIT are concerned with *substantive* law rules; they will only include uniform conflict of law rules incidentally.

The need for harmonised rules is usually driven by new technologies and commercial practices. States specifically asking for new solutions or transactions which are **transnational** by their very nature. UNIDROIT will assess whether states are willing to accept change to their municipal law rules in favour of a new international solution on that subject before embarking on the process. Some rules are restricted to truly cross-border situations or relations while others are extended to cover purely internal situations or relations.

Because UNIDROIT is an intergovernmental structure, its rules have traditionally tended to take the form of **international conventions**. These apply automatically in preference to a state's national law once they have been implemented. Conventions are needed where:

- The scope of rules affect third parties as well as the parties to a contract, or
- The interests of third parties or the public interest are at stake, as in the law of property.

Exam focus point

Exams often require candidates to explain the role of specific organisations. For example, in June 2008 – UNCITRAL and UNIDROIT.

Since states often drag their heels in implementing conventions, UNIDROIT has more recently favoured alternatives such as:

- **Model laws** to be taken into consideration when drafting domestic legislation on the subject covered
- **General principles** addressed directly to judges, arbitrators and contracting parties who are then left free to decide whether to use them or not
- **Legal guides**, typically on new business techniques, on new types of transaction or on the framework for the organisation of markets at both the domestic and the international level.

UNIDROIT has over the years prepared over seventy studies and drafts. Many of these have resulted in international instruments, and its work has also served as the basis for international instruments adopted under the auspices of other international organisations already in force. For example, the UNCITRAL Convention on Contracts for the International Sale of Goods.

4 Court-based adjudication

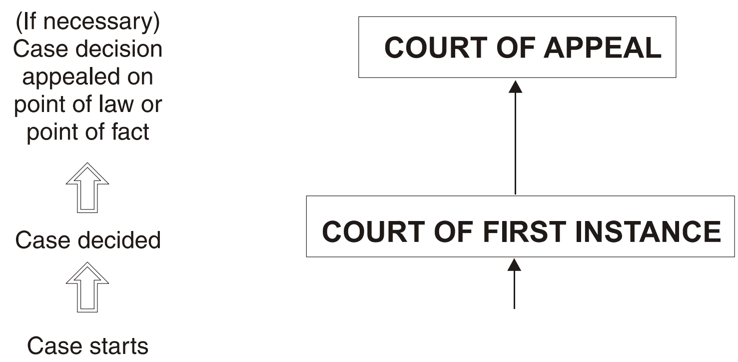
Legal disputes, of whatever nature, have **traditionally** been **settled in courts**. In fact, as we have seen, in the common law system courts have a key role in settling disputes, and in so doing, creating legal precedent, and therefore, creating law.

Most countries have a **system of courts**, with lower level courts for minor matters and higher level courts for more serious matters, and also to hear appeals when court decisions are disputed.

FAST FORWARD

Court-based adjudication depends on a **system of courts** which settle disputes. A **court of first instance** is a court where a case is heard for the first time. An **appellate court**, or **court of appeal**, is a higher court where the previous decision of a lower court can be re-heard, due to a dispute over a point of law or point of fact in a decided case. Civil and criminal cases tend to have different court structures and procedures.

Most legal systems will have a system of courts that, in its most basic form, resembles the following diagram.



However, in most countries, the court system will be **more complicated** than the one illustrated above. Most countries will have different courts to deal with civil and criminal law, and may also have different courts within those systems to deal with major and minor cases. The number of judges, and the existence of a jury will differ between those courts as well.

In the rest of this section we shall use the **example of the English court system**.

4.1 English system of courts

FAST FORWARD

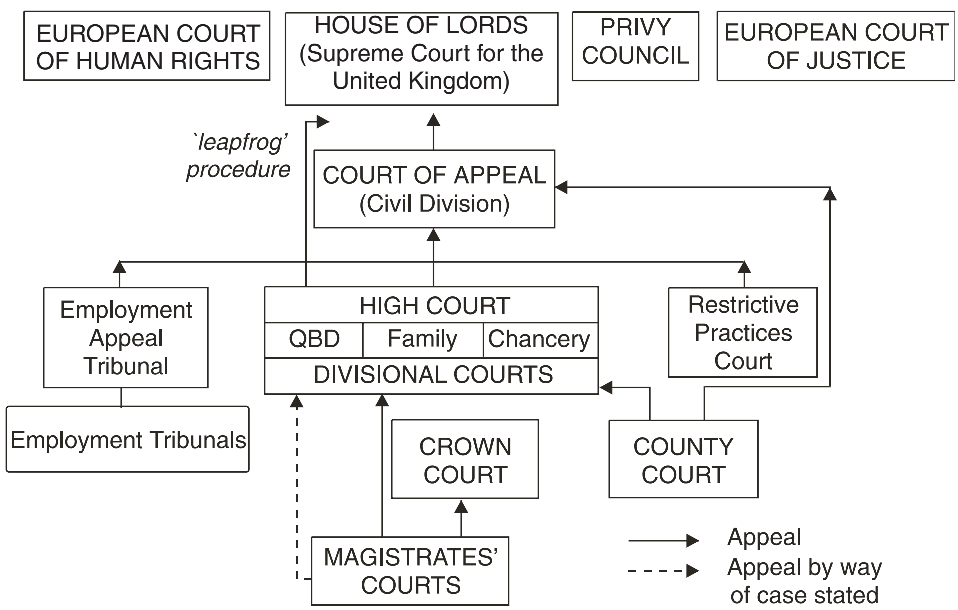
In England there is a **different court structure** for **civil** and **criminal** law, although some of the higher courts have jurisdiction over both types of law.

The system is **decentralised** through a **system of local courts**, so that smaller matters can be dealt with where they have occurred. However, the largest cases are tried in the major courts in the capital city, London.

There is a system of review to higher courts. The English legal system contains a series of **appeal courts**. Cases in either type of law may be appealed up to four times, with the highest court of appeal being the European Court of Justice, due to the UK's membership of the EU.

4.1.1 Civil court structure

The diagram below sets out the **civil** court structure for England.



The key courts in the civil system are:

- The **County Court**, which only has civil jurisdiction and which deals with almost every type of civil case at a local level.
- The **High Court**, which deals with the most major cases at first instance and is sometimes a court of appeal from the County Court.
- The **Court of Appeal**, which is the major appeal court in civil matters.

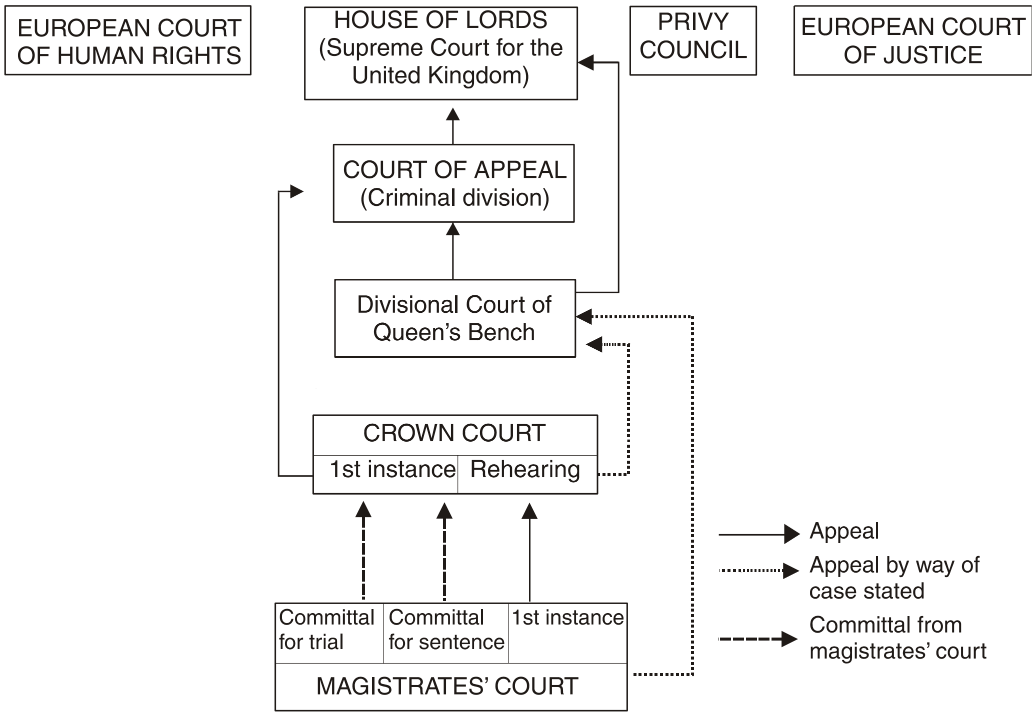
The County Court is manned by **circuit judges**, who must be barristers (qualified legal advocates) of at least 10 years' standing. Circuit judges usually hear cases also, except in very rare instances, circuit judges will be assisted by a jury of 8 persons.

The High Court is manned by **puisne judges**, who must also be barristers of 10 years' standing. They hear cases at first instance alone, but at least two judges must hear appeal cases.

The Court of Appeal is manned by **Lord Justices of Appeal**, who are judges promoted from the High Court. Three judges normally sit together, and cases are decided by a majority.

4.1.2 Criminal court structure

The diagram below sets out the English **criminal** court structure.



The key courts in the **criminal system** are:

- The **Magistrates' Court** and the **Crown Court**, which are local courts hearing the bulk of criminal cases
- The **Court of Appeal**.

The Crown Court hears cases at first instance and is an appeal court from the Magistrates' Court. Cases are appealed from the Crown Court to the Court of Appeal.

There are two types of magistrate: **lay magistrates**, who are not legally qualified and sit part-time, and **district judges**, who are solicitors (legally qualified persons) or barristers of at least 7 years' standing. Most magistrates are lay magistrates and two or three of them must sit together to hear a case. District judges sit alone.

The Crown Court is staffed by **circuit judges** or, sometimes, **lay magistrates**.

Key terms

Indictable offences are more serious offences that can only be heard in a Crown Court.

Summary offences are minor crimes, only triable summarily in Magistrates' Courts.

Some offences are **'triable either way'**.

4.1.3 Making a civil claim

Civil procedure in England has been reformed in recent years to try and reduce the cost and time involved in taking a matter to court. Therefore, it is possible to take small claims to court under a small claims procedure, where it is not necessary to engage a legal professional, and the case should be heard reasonably quickly.

However, for **larger cases** in the County Court or High Court, the **cost and time involved can be substantial**. In larger cases, it is practice for the parties to appoint **solicitors** (qualified legal professionals) to establish the facts in the case. In addition, the solicitors will often appoint **barristers** (qualified legal advocates) to present the case.

Taking a case to court can be a slow process, and if a case is appealed, it is likely to take **years** rather than **months** to reach final settlements.

An important feature of the English system is the concept of **pre-trial disclosure**. This is the practice of disclosing documents relevant to the case to the other party before trial proceedings.

Pre-trial disclosure can result in a lot of **expense**, as it can involve a significant amount of time and therefore legal cost.

4.2 Advantages and disadvantages of court-based adjudication

FAST FORWARD

Court is generally **expensive** and **slow**, but offers a wider range of better, more enforceable solutions.

It is usually more **expensive** to go to court than to submit your case to arbitration, mediation or conciliation (see later). The main reason for this is the cost of legal professionals, and court fees and, in common law systems, the cost of pre-trial disclosure, which can be high.

Another disadvantage is the **time scale** involved. The UK Government has sought to make court action more accessible to the public but taking a legal dispute to court can still be a lengthy and very costly business, particularly if the matter is subject to appeal.

A related disadvantage is the **waiting period** before a case comes to trial anyway. This can be substantial due to the large number of cases going through the court system, and, in common law systems, the time it takes to conduct pre-trial disclosure.

However, going to court can provide helpful legal **solutions** and settlements. For example, a **court order** to prevent someone from behaving in a certain way, or an order for **compensation**. In some cases, parties may want a **decision** made about which party is legally '**right**'.

5 Alternative dispute resolution (ADR)

FAST FORWARD

It is increasingly common practice in commercial contracts or agreements to include a clause providing that the dispute is to be settled by **arbitration**. Arbitration is one example of **alternative dispute resolution** (ADR), which also includes **mediation** and **conciliation**.

Key term

Alternative Dispute Resolution is any type of procedure or combination of procedures voluntarily used to resolve differences, other than court based adjudication. ADR procedures may include but are not limited to, conciliation, facilitation, mediation, early neutral evaluation, adjudication, and arbitration.

5.1 Arbitration

Key term

Arbitration is settlement of a dispute by an independent person usually chosen by the parties themselves.

Arbitration can produce different solutions to court-based adjudication. For example, it could produce the following results:

- A change in the way a person or organisation behaves
- A promise that a person or company won't do something
- An apology
- An explanation for what happened
- A mistake corrected
- Compensation

An **agreement** between parties to submit any dispute that may arise to **arbitration** is a **contract**, which is subject to the rules of contract law (we shall see these in a later chapter).

We shall look in the next chapter at the **UN's model arbitration law**, but it is useful now to identify that it is founded on the following **principles**:

- The need to obtain a fair resolution by means of an independent tribunal without unnecessary delay or expense
- The fact that parties are free to agree how arbitration should work, subject to such safeguards as are necessary to protect the public
- The fact that courts should not intervene except as necessary to protect the public interest

Although ideally there is no room for courts in a dispute submitted to arbitration, there should still be room for **appeals to courts**.

5.1.1 Arbitration in Islamic law

Islamic arbitration is known as **Takhim**. Arbitration is highly recommended in Islamic law.

The law concerning who may be an arbitrator is strict, like the law concerning who may be a judge. The qualifications needed are similar, particularly that the arbitrator must be Muslim, male, just, learned in Sharia and free from any defects that could affect his ability to arbitrate.

5.2 Mediation and conciliation

Mediation and **conciliation** involve the use of an independent third party to assist the parties in coming to their own solution of the problem. Mediation agreements are usually not legally binding on the parties.

5.3 Advantages and disadvantages of alternative dispute resolution

A major advantage of ADR is that the parties are involved in choosing the person who is going to settle their dispute. This means that they can gain the services of an **expert** in the particular commercial field that they are in.

It is sometimes argued that ADR is **cheaper** than court action, although this will depend on the practices of the nation that proceedings are being taken in. For example, in England and the US, the cost of going to court is high, due to the high cost of legal representation. It might be cheaper to go to arbitration, where legal representation is not always necessary.

However, in other countries, where the cost of court action is not so high, it might be more expensive to go to arbitration. For example, where the costs of the arbitrator and the venue must be met. In comparison, judges and court costs are shouldered by the state.

Another advantage is that ADR is usually **private**, unless the parties want the proceedings to be public. If the dispute is over a commercially sensitive matter, this may be essential to the parties. Even if the matter is more routine, the parties may not want any publicity about their dispute process. Court proceedings are usually kept on record and open to the public.

ADR is **informal** and **quicker** than court proceedings.

Question

Court v arbitration

What are the relative advantages of court proceedings and arbitration?

Answer

The **court** system **may be cheaper** than arbitration, where the arbitrator's remuneration and the venue costs have to be met.

More importantly, most court systems have an entrenched system of **appeal** to higher courts, so that an unsatisfactory decision can be challenged, usually more than once if necessary.

In addition, **judges** may be **more skilled** than unqualified arbitrators in **hearing evidence** and **drawing conclusions**.

However, a key advantage of **arbitration** is that the **parties are entitled to appoint the arbitrator**. This gives them **control** over who hears their dispute. They can choose an **expert** in the field, and may choose a legally **qualified** arbitrator, who will have similar skills to a judge.

The **venue**, **timing** and degree of **formality** of arbitration are likely to be more **flexible** than court action, which will benefit the parties.

In some countries, it may also be **cheaper** to go to arbitration as there is less need for expensive legal representation. Also, as the proceedings are less adversarial than court action, there is more likelihood of a **compromise**.

Another important issue is **privacy**. Proceedings in arbitration are usually private, so the parties can keep sensitive information private and do not have to manage the potential publicity associated with a court case.

Lastly, the parties can determine prior to the dispute arising whether any arbitrator's decision may be appealed. This can lead to lack of flexibility, but also will provide a restriction on cost, if the arbitrator's decision is final.

6 Role of international courts in trade

FAST FORWARD

International adjudicators include **international courts** (ECJ) and international venues for **arbitration** (ICA). They can sort out **conflicts of law** and the **enforcement** of settlements.

When international legal problems need solving, problems can arise due to the issue of **conflicts between the participants' laws** and the problems of **enforcing punishment or settlement** on persons in different countries.

We have discussed some of the solutions to the conflicts of laws problem above. States may also co-operate with one another, for example by **extraditing** criminals from one country to another.

International adjudication and arbitrations are also important, especially in the promotion and regulation of international trade. We shall look at the **European Court of Justice** (ECJ), is a result of the treaties between the European nations forming the European Union.

There are various international venues for **arbitration** in various countries in the world. We shall look in particular at the International Court of Arbitration.

6.1 European Court of Justice (ECJ)

The EC's **European Court of Justice (ECJ)** is part of the legal system of each member state.

The ECJ is ordered along **civil law lines**, but an unofficial system of **precedent** can arise where national states are reluctant to refer similar cases to the ECJ once a clear decision has been made.

The **ECJ is the highest court in the EU** and is the result of the treaties between the member states of the EU. It is the highest court of appeal in each member state of the EU.

6.2 International Court of Arbitration (ICA)

The **International Court of Arbitration (ICA)** is a body set up by the International Chamber of Commerce in 1923. It is composed of members from every continent in the world.

The ICA has been instrumental in developing the use of international commercial arbitration and initiated the 1958 New York Convention. This is an important multi-lateral treaty by which ratifying states agreed to recognise written arbitration agreements and not submit such disputes to national courts.

Exam focus point

You should not let the name of this institution confuse you in the exam. It is called a court of arbitration, but is not a court in the sense of the courts we looked at earlier. It is an arbitration body, which applies rules of arbitration set out by the International Chamber of Commerce.

Arbitration is a useful tool for settling **international commercial disputes**, when people trade in states where the legal system is very different from their own and legal decisions may not seem fair.

The ICA oversees all aspects of the arbitration process, such as:

- Appointment of arbitrators
- Confirmation of appointment of arbitrators
- Deciding on challenges to arbitrators
- Approving arbitral awards
- Fixing arbitrators' fees

The ICA is assisted in appointing arbitrators by the member nations of the ICC, which have **national selection committees** maintaining details of potential arbitrators. However, arbitrators do not have to be selected from pre-existing lists. This means the ICA maintains the flexibility of arbitration and the benefit to the parties of being able to select their own arbitrator.

Question

Conflict of laws

Sulieman Ltd, a company incorporated in the nation state of Alland, is contracting with Ambrosia plc, a company incorporated in Beland. Both Alland and Beland have ratified the 1980 Rome Convention.

What law is likely to govern their legal relationship?

Answer

Which law governs their relationship will depend on whether Sulieman Ltd and Ambrosia plc have made a written agreement of what law they intend should govern their relationship.

If they have done so, under the Rome Convention, the law they have chosen will govern their relationship.

If they have not made a written agreement as to what law they intend to be relevant to their relationship, they may face the problem of conflict of laws (assuming that the laws in Alland and Beland are different). In this case, should any legal disputes arise, it might be necessary for the courts in Alland or Beland to try to determine what law governs their relationship.

Chapter Roundup

- **Public international law** governs the relations between states and international organisations. **Private international law** regulates cases where there is a conflict of laws.
- Barriers to free trade exist to **protect** markets from outside competition. They include: tariffs or customs duties; import quotas; embargoes; hidden subsidies for exporters and domestic producers; import restrictions, as well as the barriers created by differences in laws.
- **Conflict of laws** is where parties from different nations have a legal dispute, and it is necessary to determine which national law governs the validity of the legal situation.
- **Important bodies** associated with international law include the EU, the UN, the ICC, the WTO, the COE, the OECD and UNIDROIT.
- Court-based adjudication depends on a **system of courts** which settle disputes. A **court of first instance** is a court where a case is heard for the first time. An **appellate court**, or **court of appeal**, is a higher court where the previous decision of a lower court can be re-heard, due to a dispute over a point of law or point of fact in a decided case. Civil and criminal cases tend to have different court structures and procedures.
- In England there is a **different court structure** for **civil** and **criminal** law, although some of the higher courts have jurisdiction over both types of law.
- **Court** is generally **expensive** and **slow**, but offers a wider range of better, more enforceable solutions.
- It is increasingly common practice in commercial contracts or agreements to include a clause providing that the dispute is to be settled by **arbitration**. Arbitration is one example of **alternative dispute resolution** (ADR), which also includes **mediation** and **conciliation**.
- **International adjudicators** include **international courts** (ECJ) and international venues for **arbitration** (ICA). They can sort out **conflicts of law** and the **enforcement** of settlements.

Quick Quiz

1 What is meant by the term conflict of laws?

2 The four aims of the United Nations are:

(1) ....

(2) ....

(3) ....

(4) ....

3 The International Chamber of Commerce set up the International Court of Arbitration.

True ☐

False ☐

4 The Council of Europe and the European Union are the same body.

True ☐

False ☐

5 The two roles of the International Court of Justice are:

(1) ....

(2) ....

6 **Fill in the blanks** in the statements below, using the words in the box.

The distinction between (1) ……………….. and (2) ……………….. liability is central to most legal systems.

(3) ……………….. allows parties to bring their dispute before a non-legal independent expert so that he may decide the case.

• criminal	• arbitration	• civil

7 The two types of court that can be found in most legal systems are:

(1) ....

(2) ....

8 **Fill in the blanks** in the sentence below.

………………… ………….. ………………………. is any type of procedure or combination of procedures ……………….. used to resolve issues in controversy, other than court-based adjudication.

Answers to Quick Quiz

1 Conflict of laws is a problem that arises when people from different nation states enter into a legal relationship with each other, and it is not clear whose national law will govern that legal relationship.

2 The aims of the UN:

(1) Maintain peace and security

(2) Develop friendly relations among companies

(3) Co-operate in solving economic, social, cultural and humanitarian problems

(4) Promote respect for human rights and international freedoms

3 True. The ICC set up the ICA

4 False. They are not the same

5 The roles of the ICJ:

(1) To settle disputes before it in accordance with international law

(2) To provide advice on legal issues put before it by international organisations

6 (1) criminal (2) civil (3) arbitration

7 (1) Courts of first instance
(2) Appellate courts

8 **Alternative dispute resolution** is any type of procedure or combination of procedures **voluntarily** used to resolve issues in controversy, other than court-based adjudication.

Now try the question below from the Exam Question Bank

Number	Level	Marks	Time
Q2	Examination	10	18 mins

3

Commercial arbitration

Topic list	Syllabus reference
1 UNCITRAL Model Law on International Commercial Arbitration	A4(b)
2 Arbitration agreement	A4(b)
3 Arbitral tribunal	A4(b)
4 Conduct of arbitral proceedings	A4(b)
5 Award enforcement	A4(b)

Introduction

The concept of arbitration was introduced in Chapter 2. Here we shall look at the detail of the UNCITRAL **Model Law on International Commercial Arbitration**. We shall look at four aspects contained within the Model Law:

- What constitutes an arbitration agreement
- The arbitral tribunal
- How proceedings are conducted
- Awards and their enforcement

Many cases relating to the Convention for the International Sale of Goods which we will look at in detail in the next chapters are submitted to arbitration under this model agreement.

Study guide

		Intellectual level
A4	**Alternative Dispute Resolution mechanisms**	
(b)	Explain and apply the provisions of the UNCITRAL Model Law on International Commercial Arbitration	2

Exam guide

Given its practical nature and the fact there is a Model Law on it, arbitration is a highly examinable topic in this exam in the knowledge part of the paper.

1 UNCITRAL Model Law on International Commercial Arbitration

FAST FORWARD

Arbitration is the settlement of disputes by an independent party usually chosen by the parties themselves.

The United Nations Commission on International Trade Law adopted the Model Law on International Commercial Arbitration in 1994. It is not a Convention, but a set of rules to be adopted into national laws so as to make international practice uniform.

1.1 International commercial arbitration

FAST FORWARD

An arbitration is international if the parties have their places of business in **different states** and commercial if it arises from matters of a **commercial nature** (that is, relating to trade).

The Model Law defines what makes arbitration both **international** and **commercial** in character: Article 1.

Arbitration is **international** if:

(a) The parties to the arbitration agreement have their places of business in different states, or if the parties' places of business are in the same state.

(b) If the place designated for arbitration is in a different state, or the obligations of the commercial relationship are to be performed in a different state.

Arbitration is **commercial** if it covers matters arising from all relationships of a commercial nature, that is, relating to **trade**, whether there is a contract or not. This should be interpreted widely. The Model Law gives the following as examples of commercial transactions:

- Supply/exchange of goods and services
- Distribution agreement
- Commercial representation
- Agency
- Factoring
- Leasing
- Construction of works
- Consulting
- Carriage of goods by air/sea/road/rail
- Carriage of passengers by the same
- Engineering
- Licensing
- Investment
- Financing
- Banking
- Insurance
- Exploitation agreement or concession
- Joint venture
- Other industrial/business co-operation

If a party has **more than one place of business**, the relevant place of business for the purpose of the arbitration agreement is the place with the closest relationship to the arbitration agreement.

1.2 Written communications

The Model Law sets out a general rule about **receipt of written communications** which will be in force in any arbitration agreement, unless the parties agree otherwise.

Article 3

Any written communication is deemed to have been received if it is delivered to the addressee personally or if it is delivered at his place of business, habitual residence or mailing address; if none of these can be found after making a reasonable inquiry, a written communication is deemed to have been received if it is sent to the addressee's last-known place of business, habitual residence or mailing address by registered letter or any other means which provide a record of the attempt to deliver it.

The communication is deemed to have been received on the day it is so delivered.

1.3 Role of the courts

The Model Law specifies that **courts shall not intervene** in matters governed by the Model Law, except where stated within the Model Law: Article 5. Each state that adopts the Model Law should specify a court or other authority within the adopted law which will perform necessary functions (for example, default appointment of arbitrators) if necessary: Article 6.

2 Arbitration agreement

FAST FORWARD

An arbitration agreement is an agreement by the parties to submit **disputes** arising under a contract to arbitration.

Key term

An **arbitration agreement** is an agreement by the parties to submit to arbitration all or certain disputes which have arisen or which may arise between them in respect of a defined legal relationship, whether contractual or not: Article 7(1). An arbitration agreement may be in the form of an arbitration clause or in the form of a separate agreement.

2.1 Form of the arbitration agreement

FAST FORWARD

The **Model Law** requires that an arbitration agreement be in **writing**, but this may be by written reference to a clause in another document.

As indicated in the key term above, the arbitration agreement may be a separate agreement, or may be a clause in another agreement. For example, a contract for the international sale of goods, or, as discussed in Section 1, many other commercial relationships.

Exam focus point

When answering scenario questions in the area of commercial arbitration, always look for an arbitration agreement between the parties and state that one is required before the parties can go to arbitration.

The Model Law requires that **the arbitration agreement be in writing** Article 7(2). What constitutes writing is explained in the Model Law.

Key term

A **written arbitration agreement** is one contained in a document signed by the parties or in an exchange of communications which provide a record of the agreement. It may also be in an exchange of statements of claim and defence in which the existence of an agreement is alleged by one party and not denied by another. The reference in a contract to a document containing an arbitration clause constitutes an arbitration agreement provided that the contract is in writing and the reference is such as to make that clause part of the contract.

As you can see from the key term, an agreement can be 'in writing' in three ways:

(a) It is **contained in a document** providing written evidence of the agreement.

(b) It is **referred to** by a party **in documents relating to legal proceedings** and the other party does not deny its existence.

(c) A written contract between the parties **makes reference** to another document containing an arbitration agreement.

2.1.1 Example: form of arbitration agreement

To illustrate the point in (c) above, the following situation could arise:

A and B, whose places of business are in different states, are contracting for the sale of goods by A to B in June 20X9. They have contracted on a similar basis before, in December 20X7. The December 20X7 contract contained significant detail about the relationship that was to exist between the parties, including an arbitration agreement. The December 20X7 contract was in writing.

The June 20X9 contract could be a much shorter document, detailing the goods and the price, and it might state that all other conditions of the contract are to be the same as the December 20X7 contract.

In this case, the June 20X9 contract contains an arbitration agreement, because it makes reference to a previous document containing an arbitration agreement.

2.2 Court proceedings

FAST FORWARD

The Model Law sets out how arbitration **interacts** with the court system.

If an action is brought before a court in relation to a matter which is subject to an arbitration agreement, the court should **refer the matter to arbitration**, unless they find that the clause is null and void, for example, if it was not in writing: Article 8(1).

Arbitral proceedings may be commenced where a matter is subject to arbitration, even if court proceedings have been initiated and are continuing in respect of the agreement: Article 8(2).

UN Case 57

The facts: A Hong Kong company which was a subsidiary of a Korean company (Company A) had an agreement with another Hong Kong company (Company B). The contract contained an arbitration clause providing for arbitration in a third country, under the rules of that third country and in accordance with the rules of the International Commercial Arbitration Association.

Company B sued for damages in the Hong Kong courts under the contract, claiming that the arbitration clause was null and void because it referred by mistake to an unspecified third country, or inoperative because it referred to a non-existent organisation and non-existent rules.

Decision: The court found that the clause sufficiently indicated the parties' intention to arbitrate. The references did not make it impossible to perform, because it could be performed in any country other than where the parties had their place of business and under the law of arbitration of that place.

3 Arbitral tribunal

3.1 Composition of the arbitral tribunal

FAST FORWARD

The **number of arbitrators** in the arbitral tribunal may be agreed by the parties but will otherwise be three. If the parties do not agree on how to appoint the arbitrators, each shall appoint one and the two so appointed will appoint a third arbitrator.

The **parties may determine the number of arbitrators** to make up the arbitral tribunals; **If the parties do not do so**, the Model Law states that **there will be three arbitrators**: Article 10.

The **parties may agree on how the arbitrators are to be appointed**. If they do not agree on a method, the Model Law sets out how arbitrators are to be appointed (see below). However, even if the parties agree on their own method, there are a number of **rules** which **must be observed**: (Article 11)

(a) A person will not be stopped from being an arbitrator on the grounds of his nationality.

(b) If the parties fail to appoint arbitrators by the agreed procedure, any party may request that the relevant authority or court, specified in their national law, appoint an arbitrator.

(c) If any of the arbitrators or relevant third parties to the agreement fails to perform his functions properly, any party may apply to the relevant authority or court to take action.

(d) Any decision taken by the relevant authority or court in relation to (b) and (c) will not be subject to appeal.

Appointment of the arbitrator: Article 11	
Arbitration with three arbitrators	Each party to the agreement will appoint one arbitrator. This should be done within 30 days of the request to do so. The two appointed arbitrators shall appoint a third arbitrator. This should be done within 30 days of the appointment of the first two arbitrators.
Arbitration with sole arbitrator	If the parties have agreed that there shall be a sole arbitrator, they shall agree on who that arbitrator will be. If the parties cannot agree on the sole arbitrator, either party may request that the relevant authority or court specified in their national law shall appoint the arbitrator.

3.2 Independent and impartial arbitrators

FAST FORWARD

The arbitrators should be **independent** and **qualified**. They should disclose any relevant facts that might make them not independent or impartial.

The arbitrator should be **independent** and **impartial** in relation to the matter. He should also possess any qualifications specified in the arbitration agreement: Article 11(5).

When someone is asked to be an arbitrator, they must **disclose any relevant facts** that **might make them not independent or impartial** in relation to the matter being arbitrated. They should continue to do this throughout the process of arbitration if relevant circumstances arise: Article 12.

Under Article 12, a party may **challenge the appointment of the arbitrator** if he feels the arbitrator:

- Is **not independent and impartial**
- **Does not possess the qualifications required** by the arbitration agreement

3.2.1 Challenging an arbitrator

A person **cannot** challenge an arbitrator in whose appointment they were involved on the grounds of matters of which they were aware at the time of the appointment: Article 12.

The parties may agree on the **procedures for challenging an arbitrator**. If they do not, the Model Law sets out a challenge procedure: Article 13.

If the challenge procedure agreed upon is not successful, the challenging party may **refer the matter to the relevant authority or court** within 30 days. The arbitral tribunal (including the challenged arbitrator) may continue the arbitration while such action is pending.

Challenging the appointment of an arbitrator
Any party who intends to challenge the appointment of an arbitrator must send a **written statement** of his challenge to the arbitral tribunal within 15 days of becoming aware of the grounds for a challenge.
The challenged arbitrator may **withdraw** from his office as a result of the challenge.
The other party may **agree to the challenge**, in which case the challenged arbitrator must withdraw.
If the arbitrator does not withdraw and the other party does not agree with the challenge, the **arbitral tribunal** must decide on the challenge.
If a challenge is unsuccessful, the challenger has a further **30 days** to ask the court to decide on the challenge.
Once the court has decided on the challenge, **no further appeal** may be made.
While the challenge is proceeding the original arbitral tribunal, including the challenged arbitrator, may **continue** the arbitral proceedings and make an award.

3.2.2 Arbitrator unable to act

If it becomes impossible for the arbitrator to act, his appointment is **terminated** if he withdraws from office or if the parties agree that it is terminated: Article 14. If there is any controversy about whether an arbitrator is still validly appointed, any party may **refer the matter to the relevant authority or court**. Where an arbitrator has withdrawn, a **substitute arbitrator** can be appointed on the same basis that the original arbitrators were appointed: Article 15.

3.3 Jurisdiction of the arbitral tribunal

FAST FORWARD

The tribunal can rule on **anything in its jurisdiction**.

If the arbitration agreement is a clause in a different contract, the arbitration clause shall be treated as being an independent part of the contract. This means that if the **arbitral tribunal** concludes that the contract is null and void, this does not affect the arbitration clause, and therefore the fact that the dispute should be settled in arbitration.

The arbitral tribunal may rule on anything in its jurisdiction, including on **whether an agreement contains an arbitration agreement**: Article 16.

4 Conduct of arbitral proceedings

FAST FORWARD

The parties may agree on the **procedure** to be followed. If they do not, the tribunal shall **conduct proceedings as they see fit**.

The following general rules apply to arbitration tribunal proceedings:

(a) The parties shall be treated with **equality** and each party shall be given a **full opportunity to present his case**: Article 18

(b) The **parties are free to agree on the procedure** to be followed, subject to the requirements of the Model Law: Article 19

(c) **If the parties do not agree** on a procedure, the **arbitral tribunal shall conduct the arbitration in a manner which it considers fit**: Article 19

Arbitration proceedings: general points	
Place (Art 20)	(a) The parties shall agree on the place of arbitration. (b) If the parties do not agree, the arbitral tribunal shall determine where the arbitration takes place. They shall consider the circumstances of the case and the convenience for the parties.
Commencement (Act 21)	(a) The parties shall agree upon when arbitral proceedings commence. (b) If the parties do not agree on when arbitral proceedings commence, then they commence when the request for referral to arbitration is received by the respondent.
Language (Art 22)	(a) The parties may agree what language proceedings are to be conducted in. (b) If they do not so agree, the arbitral tribunal may determine the language that will be used. The arbitral tribunal may order that documentary evidence be accompanied by translations into the language being used for the proceedings.
Experts (Art 26)	Unless the parties agree not to, the arbitral tribunal may appoint one or more experts to report to it on relevant, specific issues determined by the tribunal. If the tribunal considers it necessary, the expert may be questioned by the parties, and expert witnesses may testify.
Court assistance (Art 27)	The arbitral tribunal itself, or one of the parties, with permission from the arbitral tribunal may request assistance in taking evidence from a competent court.

4.1 Statements of claim and in defence

FAST FORWARD

The claimant must make a **statement of claim**; the defendant shall make a **statement in defence**.

The claimant (person referring the matter to arbitration) shall state, under Article 23,

- The **facts** supporting his claim
- The **points at issue**
- Any **remedy** sought

The defendant shall state his **defence** in respect of these particulars.

4.1.1 Timing

The **statements of both claim and in defence** shall be made within the period of time agreed by the parties. If they have not come to an agreement on when the statements shall be made, the arbitral tribunal may decide.

4.1.2 Other documents

The parties may include documents that they consider to be relevant with their claims, or make reference to them. The parties may also supplement their statements during proceedings.

4.1.3 Failure to provide written statements

If the claimant fails to provide his statement of claim within the time period, the arbitral tribunal shall terminate proceedings. However, if the defendant fails to provide his statement of defence, the arbitral tribunal shall not treat this as admission of guilt in itself and will continue with proceedings.

4.2 Hearings and written proceedings

FAST FORWARD

Proceedings may be **oral** or **written**.

Unless the parties have made any agreements to the contrary, the arbitral tribunal shall decide under Article 24 whether:

- To hold **oral hearings** for the presentation of evidence, or
- To conduct proceedings on the basis of **documents**

If the parties have not agreed otherwise, the arbitral tribunal shall carry out **oral hearings if requested** by one of the parties.

The parties shall be given **advance warning** of hearings or any inspection of goods or documents by the arbitral tribunal.

All statements, documents and other information from one party shall be **publicised** to the other. Any material, such as expert evidence, used by the tribunal in coming to its decision shall be made available to both parties.

If either of the parties **fails to appear** at a hearing or produce documentary evidence the arbitral tribunal will continue with the case, and will make its decision on the basis of evidence available to it: Article 25.

4.3 Challenging the jurisdiction of the arbitral tribunal

FAST FORWARD

There are rules on when and how the jurisdiction of the arbitral tribunal may be **challenged**.

If a party wants to **challenge the jurisdiction** of the tribunal to conduct proceedings, such a plea must be raised before the statement of defence is submitted: Article 16(2).

Any party may challenge the jurisdiction of the tribunal, regardless of whether they have **participated** in appointing an arbitrator.

If the arbitral tribunal concludes that it does have jurisdiction, any party may **apply to the relevant authority or court** to decide whether this decision is valid. However, it must do so within 30 days of hearing the tribunal's decision concerning its jurisdiction: Article 16(3).

4.4 Termination of proceedings

FAST FORWARD

Proceedings ends either with an **award** or with a **termination order**.

The proceedings are terminated under Article 32 when:

- An **award** is made
- An **order** of the arbitral tribunal is made to terminate proceedings.

4.4.1 Termination by order

The arbitral tribunal make an **order to terminate proceedings** when:

- The claimant **withdraws** his claim (unless the defendant with a legitimate interest in continuing with proceedings objects)
- The parties **agree to terminate** proceedings
- The arbitration has become **unnecessary** or **impossible**

BPP LEARNING MEDIA

5 Award enforcement

5.1 Interim measures of protection

FAST FORWARD

Interim measures of protection may be ordered from either party while the arbitration proceeds.

The arbitral tribunal may order either party to undertake **interim measures of protection** while arbitration is proceeding: Article 17.

5.2 Deciding the dispute

FAST FORWARD

The **decision** must be a majority one, applying the law as necessary.

The arbitral tribunal shall make its decision according to the **rules of law chosen by the parties**. If the law of a particular state is designated, the tribunal shall make its decision according to the substantive laws of that state: Article 28(1).

If the parties do not specify the appropriate laws, the arbitral tribunal may make its decision according to **the law that it sees fit to apply**: Article 28(2). In any case, the arbitral tribunal shall make its decision in accordance with custom associated with the trade applicable to the transaction: Article 28(4).

The decision shall be concluded by a **majority of the arbitrators**: Article 29.

If the **parties settle the dispute** before the arbitrators take their decision, the arbitral tribunal shall end the arbitration and **record the settlement as if it had been an arbitral award**: Article 30.

5.3 Form and content of the arbitral award

FAST FORWARD

The award should be in **writing** and signed and dated by the arbitrators. It should also state the **place** of arbitration.

Under Article 31 the arbitral award shall:

- Be in **writing**
- Be **signed by the arbitrators** (or a majority of them where there are three or more)
- State the **reasons** behind the award
- State the **date** of the award and the **place** of arbitration
- **Be copied** and these copies sent to each party

A party may, with notice to the other party, request that any **error in computation or typing** in the award be corrected by the tribunal, or that an explanation or interpretation of a point be made: Article 33. Such a request must be made within an agreed time, or within 30 days if no such time has been agreed. The tribunal may make such correction without prompting within 30 days from the award being made.

If the tribunal believes that the request is justified, it must **make the correction**, or give the explanation within 30 days of receipt of the request. The correction or interpretation becomes part of the award.

5.3.1 Additional award

A party may request that the arbitral tribunal make an **additional award** that has been referred to during proceedings, but not included within the final award: Article 33. This must also be requested within 30 days of the receipt of the award. The tribunal may make the additional award within 60 days, if it considers the request to be justified.

5.4 Recourse against arbitral award

FAST FORWARD

Parties may have **recourse** against the award, if they can show certain factors existed.

Under Article 34, parties may only apply to the relevant court or authority (as previously specified) to have the arbitral award **set aside** if:

(a) A party to the arbitration agreement was under some **incapacity** or the agreement is not valid under the laws to which the parties have subjected it

(b) A party was **not given proper notice** of an arbitrator's appointment or of the proceedings or that party was otherwise unable to present his case

(c) The award **deals with a matter not contemplated** by the parties or not falling within the terms of the arbitration agreement

(d) The **composition** of the tribunal was **incorrect**

(e) The subject matter of the dispute is **not capable of being settled by arbitration** under the law of the State

(f) The award conflicts with **public policy** in that State. However an application must be made within **three months** after the award was made, or a request under Article 33 to amend the award was rejected.

The court may **suspend** (for as long as it likes) a **setting aside proceeding**. This can give the tribunal time to resume the original proceedings or to take other actions that eliminate the need for a setting aside proceeding.

Exam focus point

The December 2008 exam included a question requiring candidates to explain the circumstances where a party has recourse against an arbitration award.

5.5 Recognition and enforcement of an arbitral award

FAST FORWARD

An arbitral award is **binding**.

Regardless of which country an arbitral award was made in, **it shall be recognised as binding**: Article 35.

To **enforce an award**, a party should make written application to the court specified under Article 36. They should supply the court with the original award made by the arbitral court or with a certified copy. If the award was not made in the official language of the state, they should provide a certified translation.

Question — Arbitration agreement

Ashford Co, an English company, is in dispute with Initiatif SA, a French company, over their contract for the provision of display equipment for Ashford's 20X3 trade show. Initiatif are late in performing the contract, and Ashford will now not be able to set the show up to their desired specifications. Ashford Co and Initiatif have a long trading relationship, and the contract currently in dispute referred to 'the usual contract terms'. Ashford and Initiatif have never had a major dispute in their trading relationship. The original contract contained a clause stating that disputes would be referred to arbitration in a third party nation. Both the UK and France are parties to the UN Model law on arbitration.

Required

(a) Explain whether Ashford Co can pursue arbitral proceedings against Initiatif.
(b) Outline what such proceedings would consist of.

Answer

(a) **Arbitration agreement**

Ashford may pursue arbitral proceedings against Initiatif if an **arbitration agreement exists** between them. The **Model Law** on **Arbitration** requires that such an agreement be **in writing**. An arbitration agreement is a written indication that the parties wish to refer disputes between them to arbitration.

Such an agreement may be contained within the agreement in dispute, or it may be a reference within that agreement to another document which contains such an agreement. In this case, since Ashford and Initiatif are trading 'on the usual terms', the latter case would appear to be relevant.

In order to identify whether Ashford Co could submit this dispute to arbitration, it would be necessary to check that the original agreement between the parties contained a clear, **written statement of their intention to submit disputes to arbitration**. This is implied in the question, suggesting that Ashford can commence arbitral proceedings.

(b) **Arbitral proceedings**

Ashford should indicate their intent to take the matter to arbitration to Initiatif.

In the absence of any specific provisions to the contrary within the arbitration agreement, the rules of the Model law will apply to proceedings. This means that each party will be entitled to choose an arbitrator and the two arbitrators chosen will then choose a third arbitrator.

The parties may challenge the appointment of any of the arbitrators if they feel that the arbitrator in question is not appropriately qualified or independent.

Due to the terms of the agreement, the arbitration will take place somewhere other than France or the UK. If the parties cannot agree what **place** this should be, the arbitral tribunal will determine a suitable place. The parties should also agree in what **language** proceedings will be carried out. In the absence of agreement, the tribunal will again decide.

Ashford should provide a statement of claim to the arbitral tribunal. This will include the facts supporting the claim, the points at issue and any remedy which is sought. In this case, as performance has been delayed and time is a key issue, this remedy sought is likely to be damages.

Initiatif can then provide the tribunal with a statement of defence in respect of the claims that have been made. Both parties may include other relevant documents in their submissions.

If Initiatif fail to provide a statement of defence in the given time period, this will not be taken to be a sign of guilt, and the proceedings will continue.

Proceedings shall be written or oral, depending on the agreement of the parties. If the parties have not agreed this point, the arbitral tribunal shall decide. The tribunal may also seek the advice of expert witnesses should it choose.

The arbitrators will then make an award based upon the evidence before them.

Chapter Roundup

- **Arbitration** is the settlement of disputes by an independent party usually chosen by the parties themselves.
- An arbitration is international if the parties have their places of business in **different states** and commercial if it arises from matters of a **commercial nature** (that is, relating to trade).
- An arbitration agreement is an agreement by the parties to submit **disputes** arising under a contract to arbitration.
- The **Model Law** requires that an arbitration agreement be in **writing**, but this may be by written reference to a clause in another document.
- The Model Law sets out how arbitration **interacts** with the court system.
- The **number of arbitrators** on the arbitral tribunal may be agreed by the parties but will otherwise be three. If the parties do not agree on how to appoint the arbitrators, each shall appoint one and the two so appointed will appoint a third arbitrator.
- The arbitrators should be **independent** and **qualified**. They should disclose any relevant facts that might make them not independent or impartial.
- The tribunal can rule on **anything in its jurisdiction**.
- The parties may agree on the **procedure** to be followed. If they do not, the tribunal shall **conduct proceedings as they see fit**.
- The claimant must make a **statement of claim**; the defendant shall make a **statement in defence**.
- Proceedings may be **oral** or **written**.
- There are rules on when and how the jurisdiction of the arbitral tribunal may be **challenged**.
- Proceedings ends either with an **award** or with a **termination order**.
- **Interim measures of protection** may be ordered from either party while the arbitration proceeds.
- The **decision** must be a majority one, applying the law as necessary.
- The award should be in **writing** and signed and dated by the arbitrators. It should also state the place of arbitration.
- Parties may have **recourse** against the award, if they can show certain factors existed.
- An arbitral award is **binding**.

Quick Quiz

1 Give five examples of commercial transactions.

(1) ....

(2) ....

(3) ....

(4) ....

(5) ....

2 What is the rule in the Model Law concerning receipt of written communications?

3 An arbitration agreement must be in writing.

True ☐

False ☐

4 If the parties do not determine the number of arbitrators, there shall be …….

5 What three things should the claimant refer to in his statement of claim?

(1) ....

(2) ....

(3) ....

6 An arbitral award must be in writing.

True ☐

False ☐

Answers to Quick Quiz

1 Examples of commercial transactions

- Supply/exchange of goods & services
- Distribution agreement
- Commercial representation
- Agency
- Factoring
- Leasing
- Construction of works
- Consulting
- Carriage of goods by air/sea/road/rail
- Carriage of passengers by the same
- Engineering
- Licensing
- Investment
- Financing
- Banking
- Insurance
- Exploitation agreement or concession
- Joint venture
- Other industrial/business cooperation

Note: Only five were required by the question.

2 Any written communication is deemed to have been received if it is delivered to the addressee personally or if it is delivered at his place of business, habitual residence or mailing address. If none of these can be found after making a reasonable inquiry, it is deemed to have been received sent to the addressee's last-known place of business, habitual residence or mailing address by registered letter or any other means which provide a record of the attempt to deliver it.

3 True. Agreements must be written

4 Three

5 (1) The facts supporting his claim
(2) The points at issue
(3) Any remedy sought

6 True. Awards must be written

Now try the question below from the Exam Question Bank

Number	Level	Marks	Time
Q3	Examination	10	18 mins

PART B

International business transactions

Contracts for the international sale of goods

4

Topic list	Syllabus reference
1 Contracts for the International Sale of Goods (UNCISG)	B1(a)
2 Ratification of the Convention	B1(a)
3 Formation of a contract for the international sale of goods	B2(a)
4 Offer	B2(a)
5 Acceptance	B2(a)
6 Counter-offer	B2(a)
7 Communication of acceptance	B2(a)
8 Modification or termination of the contract	B2(a)
9 ICC Incoterms	B1(b)

Introduction

In this chapter we introduce contracts for the international sale of goods. We mentioned in Chapter 2 that the United Nations has a Convention on sale of goods which applies to parties in member states.

In this and the next two chapters we shall look at the provisions of the Convention and some of the cases that have been decided on the basis of it.

We discussed some of the problems of contracting with people in other states in Chapter 2. Different nations will have different requirements as to what constitutes a contract. The Convention sets out requirements about **offer** and **acceptance** which we shall examine here.

Study guide

		Intellectual level
B	**International business transactions**	
1	**Introduction to the United Nations Convention on Contract for the International Sale of Goods and ICC Incoterms**	
(a)	Explain the sphere of application and general provisions of the convention	1
(b)	Explain the meaning and effect of the ICC Incoterms	1
2	**Formation of contract**	
(a)	Explain and be able to apply the rules for creating contractual relations under the convention	2

Exam guide

Application of the Convention, offer and acceptance came up in the pilot paper, so you should regard this topic as highly examinable, both as a knowledge question and as an application one.

1 Contracts for the International Sale of Goods (UNCISG)

FAST FORWARD

The UN Convention on Contracts for the International Sale of Goods (UNCISG) applies to contracts for the sale of goods between parties: whose **places of business** are in different states, when the states are **contracting states** or the rules of **private international law** lead to the application of the law of a contracting state.

We introduced the UN Convention on Contracts for the International Sale of Goods (UNCISG) in Chapter 2. Throughout this part of the Text we shall be referring in detail to its Articles.

Unless excluded by the parties (Article 6), the UNCISG applies to contracts of **sales of goods** between parties whose **places of business are in different states**,

(a) When the states are **contracting states**, or

(b) When the rules of **private international law** lead to the application of the law of a contracting state: Article 1

Its basic principles are that it is: **international**, **uniform** and **based on good faith**: Article 7.

The fact that the parties have their **places of business** in different states is disregarded if it does not appear either from the contract or from dealings between them at any time before or at the conclusion of the contract. The nationalities of the parties and their civil or commercial character, or that of the contract, are **not** taken into account when determining whether or not the contract applies.

Parties to a contract covered by the Convention are bound by any **usage** or custom to which they have agreed and by any practices established between themselves: Article 9. These practices may be those commonly accepted in a particular trade.

1.1 Example: Application of the Convention

If the contract was between parties in a contracting state and a non-contracting state, and the parties agreed that the **relevant law** for the contract is the national law of the contracting state, the Convention would apply to that contract.

The Convention does not apply to the **liability of the seller for death or personal injury** caused by the goods to any person: Article 5.

1.2 Sales of goods

FAST FORWARD

A **sale of goods** is an agreement by which the seller transfers, or agrees to, the property in goods to a buyer for monetary compensation, called the price.

Key terms

Sales of goods can be defined as a contract by which the seller transfers, or agrees to transfer, the property in goods to a buyer in exchange for monetary compensation, called the price.

'**Property**' in this context means legal title.

By Article 2, the Convention does not apply to sales of goods bought for **personal, family or household use**. This is unless the seller neither knew, or ought to have known, that the goods were bought for that use. It also does not apply to:

- Goods bought by auction
- Goods bought on execution of/by authority of law
- Stocks, shares, investment securities, negotiable instruments or money
- Ships, vessels, hovercraft or aircraft
- Electricity

The Convention **does not apply** to the **supply of services**, or contracts where the **main obligation** of one of the parties is the **provision of labour**. It also does not apply to contracts of manufacture where the **buyer provides the substantial part of the materials** for manufacture or production: Article 3.

UN Case 105

The facts: An Austrian company ordered brushes and brooms from a company in the former Yugoslavia but provided the materials for the production.

Decision: The Convention was not applicable because the Yugoslav company was predominantly providing labour under the contract.

The Convention applies only to the formation of **contracts of sale**, and the rights and obligations of the buyer and seller arising from them. It is not usually concerned with the contract's validity or usage, nor with the effect of the contract on the property in goods sold: Article 4.

1.3 Place of business

You should note that the Convention refers to **place of business**, not nationality. If either of the parties to the contract has **more than one place of business** and these places of business are in different states, the relevant place of business will be the **one most closely connected to the contract** and its performance: Article 10.

If either of the parties does not have a place of business, the relevant place will be the party's **habitual residence**: Article 10.

2 Ratification of the Convention

2.1 Example: states in territories with different laws

If a state has two or more territorial units in which different laws are applicable (for example, the UK has England and Scotland) it may declare whether this Convention extends to **all its territorial units** or **just some of them**.

The UNCISG has to be **ratified**, **accepted** or **approved** by member states. When doing so, member states may declare that they are not bound by parts of the Convention. If they make such a declaration, they are not considered to be contracting states so Article 1(1) does not apply: Article 92.

Two or more contracting states may ratify the Convention but '**opt out**' of the Convention in relation to each other, or in relation to persons whose places of business are in each other's states: Article 94.

Contracting states whose national legislation requires contracts to be in writing may effectively **disapply** the UNCISG in respect of its provisions which allow contracts not to be in writing: Article 96.

FAST FORWARD

A state which ratifies the Convention may declare itself **not bound** by certain provisions, in which case it is not a contracting state. However, declaring that contracts must still be in writing because that is the national law does not prevent it being a contracting state.

3 Formation of a contract for international sale of goods

FAST FORWARD

A contract for the international sale of goods is formed when a valid offer is **validly accepted**.

A contract for the international sale of goods is concluded when **acceptance of an offer** becomes effective.

The Convention states that a contract for the sale of international goods **does not have to be in or evidenced by writing**. There are no other requirements as to form, and it can be proved by any means, including witnesses: Article 11. This may be disapplied if one of the parties is in a contracting state which requires writing: Articles 12 + 96. 'Writing' includes telegram and telex: Article 13.

4 Offer

FAST FORWARD

Offer is a **sufficiently definite proposal** for concluding a contract addressed to one or more persons. An offer is sufficiently definite when it indicates the goods in question and makes provision for quantity and price. An offer becomes effective when it reaches the offeree and can be ended by being withdrawn, revoked or rejected.

Key terms

An **offer** is a proposal for concluding a contract addressed to one or more specific persons that is sufficiently definite and that indicates the intention of the offeror to be bound by acceptance: Article 14.

An **invitation to treat** or to make offers is any other proposal, unless the person making it clearly indicates to the contrary: Article 14.

4.1 'Sufficiently definite'

An offer is **sufficiently definite** when

- It indicates the goods in question, and
- It makes provisions for price and quantity of the goods: Article 14

UN Case 53

The facts: A US company carried out extensive negotiations with a Hungarian company to manufacture aircraft engines. The US company made two alternative offers and did not quote an exact price.

Decision: The court of first instance decided that a valid contract had been concluded. However, on appeal, the US Supreme Court found that the offer and acceptance were both vague. They didn't explicitly, or by implication, fix the price or make provision for that price to be determined. The acceptance was merely an expression of the intention of the Hungarian company to conclude a contract. Thus no valid contract had been formed.

4.2 Commencement of offer

The offer becomes **effective when it reaches the offeree**: Article 15. An offer 'reaches' the offeree when

- It is made orally to him
- It is delivered by other means to him personally, at his place of business or mailing address
- If there is no business or mailing address, it is delivered to him personally at his habitual residence: Article 24.

This 'reaching' rule applies to **offer**, **acceptance** and any other indication of **intention**, such as withdrawal or revocation. A delay or error in the transmission of the communication, or its failure to arrive, does not deprive that party of the right to rely on the communication: Article 27.

4.3 End of offer

An offer may come to an end in the following ways:

- Withdrawal
- Revocation
- Rejection

Even an irrevocable offer may be **withdrawn** if the withdrawal reaches the offeree before or at the same time as the offer: Article 15. Remember, the rules for the withdrawal reaching the offeree are the same as for the offer reaching the offeree.

An offer may be **revoked** if the revocation reaches the offeree before acceptance (see below) is despatched (Article 16).

There are certain instances in which an offer may **not be revoked**: Article 16. These are where:

- The offer was irrevocable, or
- It was reasonable to assume the offer was irrevocable, and the offeree acted on that assumption

Key term

An **irrevocable offer** is one that indicates that it is, whether by means of it stating a fixed time for acceptance or otherwise.

Exam focus point

Exam questions may ask you to explain two or three aspects of contract law. For example, in June 2008, offer, invitation to treat and counter-offer were tested.

An offer, even one which is irrevocable, is terminated by **rejection** when rejection reaches the offerer: Article 17. As we shall see later, acceptance which contains additions or limitations or other modifications to the offer is a **counter-offer**, which rejects the offer and terminates it: Article 19.

Question — Offer

Penguin Co is in negotiations with Bailey Inc, a company in a different country from Penguin Co. Penguin Co wants Bailey Inc to manufacture 100,000 garden rakes. Penguin Co will supply the wooden handles and Bailey Co will make and fit the rake heads.

Two days ago, Penguin Co faxed Bailey Inc a document setting out the terms on which they wanted to contract. These terms included a reference to the 100,000 rakes and set out a contract price. Does this fax represent a valid offer to contract under the convention?

Answer

Two things need to be considered in order to determine whether this is a valid offer for a contract for international sale of goods under the convention:

- Does the proposed contract fall within the scope of the model law?
- Is the offer sufficiently definite to be valid?

Scope

The proposed contract is for Bailey Inc to manufacture rake heads and fit them to poles supplied by the purchaser. The Convention does not apply to the supply of services, contracts where the major obligation of one of the parties is to provide labour, or where the buyer provides a substantial part of the materials necessary for the manufacture.

In this case, Penguin is providing the wooden handles and Bailey is making and attaching the rake heads. In manufacturing rakes, it seems sensible to conclude that the manufacture of the rake head is the greater part of the process. It will require a number of materials (plastics or metals and screws). Given that Bailey has to provide this part of the manufacture and materials, it would seem that Penguin is not providing the substantial part of the materials for the contract. Nor is Bailey providing solely labour. Bailey is under an obligation to provide materials of sufficient quality to manufacture the rake heads. The contract therefore appears to fall within the scope of the convention.

Sufficiently definite?

The fax contains details of the quantity of the required product and the price of the contract. It is therefore sufficiently definite to constitute an offer under the convention.

Conclusion

The fax from Penguin to Bailey is sufficiently detailed to constitute an offer under the convention, and the details of the contract do fall within its scope.

Exam focus point

You can see from the answer to this question that questions in this area will not necessarily be straightforward. You will have to be prepared to apply the principles of the Convention to a set of given facts. Although you want to get the answer right, the most important aspect of your answer will be your explanation of why you have drawn the conclusion. Remember to state the law, explain the law and apply the law.

5 Acceptance

FAST FORWARD

Acceptance is a statement **made by the offeree**, or other conduct of the offeree that indicates assent to an offer. Assent must be a statement or an act. Silence or inactivity cannot be acceptance. Acceptance becomes effective **when it reaches the offeror**.

Key term

Acceptance is a statement made by the offeree, or other conduct of the offeree, that indicates assent to an offer (Article 18).

Acceptance must be a **statement** or **an act**, such as the despatch of goods or payment of an agreed price. Silence or inactivity does **not** constitute acceptance.

BPP LEARNING MEDIA

UN Case 95

The facts: A Swiss buyer sent an order to an Austrian seller. The seller had sent the buyer a written confirmation. The buyer failed to react. When the seller sued for the price, it argued that a contract had been concluded.

Decision: The court decided that the letter of confirmation constituted acceptance under both Swiss and Austrian law, and the parties should have known that. The exchange of confirmations was also consistent with how the parties had dealt with each other in the past. Acceptance was therefore valid, and a contract had been concluded and the seller was entitled to payment.

5.1 Commencement of acceptance

Acceptance becomes **effective the moment that the indication of assent reaches the offeror**: Article 18.

The **exceptions** to this rule are that **acceptance is not effective** when:

- Acceptance has not reached the offeror within a fixed timescale (if relevant)
- Acceptance has not reached the offeror within **reasonable time**

5.1.1 Reasonable time

Reasonable time will be judged in relation to the **method of communication** that was used by the offeror. An **oral offer** must be **accepted immediately** unless the circumstances indicate otherwise: Article 18.

5.1.2 Example

If an offeror made an offer by post, it is reasonable that acceptance could take several days, as it would be reasonable for acceptance to be posted in return.

5.1.3 Acceptance by an act

When an offer or the past transactions between the offeror and offeree indicate that the offeree may indicate his assent by performing an act, **acceptance is effective as soon as the act is performed**.

Such acceptance is only effective if the act is performed in the correct time period: Article 18.

Question

Acceptance

Reeve Co has supplied Laurel Inc wooden pallets on demand over the course of the past five years. Laurel Inc faxed Reeve Co a new order yesterday, setting out the quantity required and the price. Reeve Co has not contacted Laurel Inc in response to the fax, but has commenced manufacture on the pallets. Has Reeve Co accepted the offer?

Answer

Acceptance must be a **statement** or an **act**. Reeve Co has not made a statement to the buyer, but has commenced manufacture of the pallets, which is an act.

Whether this act will be **sufficient to constitute acceptance** in this case **will depend** on what the fax said, or, given that the parties have been contracting for a substantial period of time, the **past transaction**s between the parties.

The fax containing the offer from Laurel Inc may have indicated that acceptance by an act is acceptable. Alternatively, if the **past practice** of Reeve has been to carry out the order without acknowledging the acceptance any other way, then this will be considered acceptable acceptance, assuming that they deliver the order within a **reasonable time**.

6 Counter-offer

FAST FORWARD

A **counter offer** is a reply to an offer which **purports to be acceptance** but which **varies the terms** of the offer. **Minor variations** to the offer may not be counter offer, unless the offeror **objects to them** without undue delay.

Key term

A **counter offer** is a reply to an offer which purports to be acceptance but which contains additions, limitations or other modifications to the terms of the offer: Article 19.

An indication that contains such additions, limitations or modifications that **do not materially alter the terms of the offer is an acceptance of that offer**. The terms that form part of the contract will be the altered terms.

If the **offeror objects** to the new terms, without undue delay, either orally or by notice, the acceptance will not be effective.

Examples of what might constitute material alteration of the terms would be a **significant change to the price** or the **quantity** of goods being provided, the **time** or **place of delivery** or a change to **how disputes are to be settled**.

However, if the offeror had mistakenly used an old price and in the buyer's confirmation they had replaced it with the more up-to-date price, this would be a **small modification** that would stand unless the offeror objected.

7 Communication of acceptance

FAST FORWARD

Acceptance must reach the offeror within the time specified by the contract or within a reasonable time. There are certain rules governing **communication of acceptance**.

As discussed above, an acceptance is only valid if it reaches the offeror in **reasonable time or within a fixed time fixed by the contract** (Article 18). The period of time commences:

- From the moment the telegram containing the offer is handed in
- From the date shown in the letter containing the offer or on the envelope
- When an offer contained in instantaneous communication reaches the offeree: Article 20

Official holidays and **non-business days** are included within the time period. If acceptance cannot be delivered because the last day of the time period is a non-business day or a holiday, an extra business day is given to effect delivery.

However, **late acceptance** can be valid, if the offeror orally accepts it without delay or dispatches a notice to that effect (Article 21). Also, if there has been a problem with delivery of acceptance, late acceptance is valid unless the offeror orally informs the offeree that the offer has lapsed, or dispatches a notice to that effect.

7.1 Withdrawal of acceptance

Acceptance may be **withdrawn** if the withdrawal reaches the offeror before or at the same time as the acceptance would have become effective: Article 22.

Question — **Formation of contract**

Sentiero SA has been in negotiations with Betula Plc for a new contract, to produce several new ship engines. Various documents have passed between the parties, including quotations for engines to different specifications. The most recent quotation Sentiero sent Betula set out a proposal for three engines to different specifications. Each of them had a price attached, on average 20% of each was for labour.

Betula sent an order to Sentiero on the basis of the quotation. The next day they realised a minor amendment they wished to make to the quotation. They faxed Sentiero outlining that they withdraw the offer made in the post and outlined the terms on which they do want to offer the contract, with reference to the quotation, but including an amendment.

Sentiero received the letter in the post and faxed back accepting the contract. The fax was not delivered to the contracts manager, and the contract was performed to the original specification.

Outline what matters will be considered in determining whether Betula will have to accept the goods made to the original specification.

Answer

The court would consider whether a contract has been validly formed in this instance.

Matters to consider:

- Whether a valid offer was made to Sentiero

  This will involve considering whether the original offer was withdrawn effectively by the fax. This will involve determining whether the withdrawal 'reached' Sentiero before the offer was received. It will also depend on whether the new offer's references to the quotation constituted a sufficiently definite offer.

- Whether a valid acceptance was made to Betula

  This will depend on whether the original offer was open to be accepted, as Sentiero could not have accepted the second offer which they were not aware of.

  If the original offer had been validly withdrawn, it could not have been accepted by Sentiero, in which case, no contract has been formed and Betula will not have to accept the goods. However, if it was not withdrawn, Sentiero has indicated assent to the original offer by a reasonable method of communication and this would constitute valid acceptance if the offer was open to be accepted.

8 Modification or termination of the contract

FAST FORWARD

A contract may be **modified or terminated at any time** provided the parties agree.

Under Article 29, a contract once formed may be **modified** or **terminated** by the mere agreement of the parties.

The UNCISG governs the formation of the **contracts** and **obligations** of the parties in those contracts to which it applies. It does not set out any internationally agreed terms for the contract and to the relative risks and responsibilities of the parties in getting goods from one part of the world to another.

9 ICC Incoterms

FAST FORWARD

Seller and buyer may include an **Incoterm** in their contract, defining the **risks and responsibilities** borne by the parties in getting goods from one part of the world to another. They cover issues to do with **carriage, insurance, risk, customs documentation and duties/taxes**.

You will remember from Chapter 2 that the ICC is the International Chamber of Commerce. It has developed '**Incoterms**', that is, '**international contract terms**', which are **standard trade definitions commonly used** in international sales contracts.

There are **thirteen** Incoterms divided among four categories:

	Goods are made available to the buyer:
'E' terms	on departure at the Exporter's (seller's) premises, so no carriage costs are included in the price
'F' terms	to a carrier appointed by the buyer, so the main cost of carriage is unpaid but the cost of carriage to the carrier is included in the price
'C' terms	main cost of carriage is included in the price but the seller does not assume the risk for loss or damage to the goods after shipment
'D' terms	all costs are included in the price and the seller takes on the risk of bringing the goods to the *country* or *premises* of the buyer.

The main **issues in international trade** that are addressed by deciding to use particular Incoterms are:

- Who pays for carriage from the seller to the buyer ie how far are **carriage costs** included in the contract price?
- Who bears the **risk** that damage will occur to the goods at any point in time?
- Who bears the cost of insuring against this risk ie how far are **insurance costs** included in the contract price?
- Where does **property** in the goods pass?
- Where does **risk** pass?
- Who pays customs duties ie how far are **customs costs** included in the contract price?
- Who raises customs documentation?

The Incoterms range from the **most basic deal** (**EXW**, where the seller simply makes goods available at its premises in the country of export) to the **most all-encompassing deal (DDP**, where the seller delivers to a place in the country of import named by the buyer, having sorted out all the insurance and customs issues, and having paid all the tax, insurance and carriage costs). The **level of service** should be reflected in the **contract price** agreed between buyer and seller, but that is for the parties to agree. **Incoterms determine responsibilities, not the amount of the contract price**.

We shall look at the terms here. Although the **obligations** associated with contracts using Incoterms are not legal requirements, they will affect the rights and duties of parties if incorporated into the contract.

Exam focus point

Where Incoterms are examined, candidates are usually required to explain three of them. As you cannot guess which will be tested, it is important to learn all of them.

9.1 Ex works (EXW)

Under such a contract, the seller has **minimum obligations** with respect to delivery. He simply has to make the goods available to the buyer at his own place of business (works).

9.2 Free carrier (named place) FCA

Under this term, the seller fulfils his obligations when the goods have been **cleared for export** and handed over to the carrier named by the buyer at a named point.

9.3 Free alongside ship (FAS)

This term can only be used when goods are being transported by ship. It means that the seller discharges his obligations to deliver the goods when the goods have been placed **alongside the ship** at a named port of shipment in the country of export. The buyer bears all risk from that moment. This term should not be used if the buyer is not capable of carrying out export formalities.

9.4 Free on board (FOB)

The term FOB is usually followed by the name of the port of departure of the goods from the country of export. A FOB contract is one where the **buyer** makes arrangements for shipping and the **seller** discharges his duty by putting the goods on board the ship. This is the default position.

In such a contract, the seller does **not** have obligations in respect of carriage or insurance of the goods after he has placed them on the vessel. However, he is required to provide any export licence or other authorisation required at his own expense and bear the risk and expense of the goods until they are on the vessel.

Thereafter, the buyer must bear responsibility for risk of the goods from when they are on the vessel and obtain any **import licences** required.

9.5 Cost and freight (CFR)

This term can only be used when goods are being transported by ship. This is because the seller **pays for all costs and freight** (carriage) to take the goods to a named port of destination in the country of import, but once the goods have 'passed the ship's rail' in the exporting country port, the goods become the risk of the buyer. The seller is therefore required to clear the goods for export, and the buyer arranges and pays for marine insurance.

9.6 Cost, insurance and freight (CIF)

Under a CIF contract, the seller is required to **bear the cost of insurance** and **freight** (carriage) for the goods.

The seller must contract for carriage on the usual terms for the goods to the named port of destination by the usual route and in the way normally used for such goods.

In terms of insurance, he must obtain insurance for the goods that enables the buyer to claim directly from the insurers in the event of loss. This should be with an insurance company of good repute. The minimum insurance cover should be that which is stated in the contract plus 10%.

9.7 Carriage paid to (CPT)

This is where the seller pays for carriage to a **named location**. The risk for the goods passes from seller to buyer when the goods reach their destination.

9.8 Carriage and insurance paid to (CIP)

This is where **carriage and insurance** are paid by the seller up to a named destination and thereafter, the buyer assumes costs, such as import duties and other taxes.

9.9 Delivered at frontier (DAF)

The seller is responsible for clearing the goods for export and delivering the goods to a **named place** at the **frontier** of the **exporting country**, before the customs border of the importing country. The buyer is therefore responsible for import costs and taxes. This is often used when goods are being delivered by rail or road.

9.10 Delivered ex ship (named port of destination) (DES)

In this case, the seller fulfils his obligations when the **goods reach the named port** of importation, but the seller is not responsible for clearing the goods through customs at that port. In other words, the buyer takes over responsibility for the goods before they come off the ship in the importing country.

9.11 Delivered ex quay (duty paid) (DEQ)

The seller bears all the **costs of importation** to the point when the goods are landed in the importing country. The difference is that the obligations of the seller cease when the goods are available to the buyer at the named port in the importation country.

9.12 Delivery duty unpaid (DDU)

This means that the seller fulfils his obligation to deliver when the goods have been **made available** at a **named place** in the **country of importation**. The seller pays all the costs of getting the goods to that place, except duties and taxes and any other official charges in that country.

9.13 Delivered duty paid (DDP)

This in effect the opposite to the EXW term, which represents the minimum obligation for the seller. DDP means that the seller is obliged to **deliver goods** to a **named place** in the **country the goods are being imported** to, **with all duties relating to that importation paid**.

Chapter Roundup

- The UN Convention on Contracts for the International Sale of Goods (UNCISG) applies to contracts for the sale of goods between parties: whose **places of business** are in different states, when the states are **contracting states** or the rules of **private international law** lead to the application of the law of a contracting state.
- A **sale of goods** is an agreement by which the seller transfers, or agrees to, the property in goods to a buyer for monetary compensation, called the price.
- A state which ratifies the Convention may declare itself **not bound** by certain provisions, in which case it is not a Contracting State. However, declaring that contracts must still be in writing because that is the national law does not prevent it being a contracting state.
- A contract for the international sale of goods is formed when a valid offer is **validly accepted**.
- Offer is a **sufficiently definite proposal** for concluding a contract addressed to one or more persons. An offer is sufficiently definite when it indicates the goods in question and makes provision for quantity and price. An offer becomes effective when it reaches the offeree and can be ended by being withdrawn, revoked or rejected.
- Acceptance is a statement **made by the offeree**, or other conduct of the offeree that indicates assent to an offer. Assent must be a statement or an act. Silence or inactivity cannot be acceptance. Acceptance becomes effective **when it reaches the offeror**.
- A **counter offer** is a reply to an offer which **purports to be acceptance** but which varies the terms of the offer. **Minor variations** to the offer may not be counter offer, unless the offeror **objects to them** without undue delay.
- **Acceptance** must reach the offeror within the time specified by the contract or within a reasonable time. There are certain rules governing **communication of acceptance**.
- A contract may be **modified or terminated at any time** provided the parties agree.
- Seller and buyer may include an **Incoterm** in their contract, defining the **risks and responsibilities** borne by the parties in getting goods from one part of the world to another. They cover issues to do with **carriage, insurance, risk, customs documentation and duties/taxes**.

Quick Quiz

1 When does the UN Convention on Contracts for the International Sale of Goods apply to sales of goods?

2 **Fill in the blanks**.

…….. …. ………. can be defined as a contract by which the seller transfers, or agrees to transfer, the ………… in goods to a buyer in exchange for ………… compensation, called the ………..

3 An offer is sufficiently definite when:

(1) .... and

(2) ....

4 Name four ways an offer may end.

(1) ....

(2) ....

(3) ....

(4) ....

5 Silence may be acceptance.

True ☐

False ☐

6 **Fill in the blanks**.

A ………… ………. is a reply to an offer which purports to be acceptance but which contains …………..., ……………….. or other ………………… to the terms of the offer.

7 Acceptance is effective when the indication of assent reaches the offeror, except when:

(1) ....

(2) ....

8 Acceptance may be withdrawn if the withdrawal reaches the offeror before or at the same time as the acceptance.

True ☐

False ☐

Answers to Quick Quiz

1 It applies to contracts of sale of goods between parties whose places of business are in different states, when the states are contracting states or when the rules of private international law lead to the application of the law of a contracting state.

2 **Sales of goods** can be defined as a contract by which the seller transfers, or agrees to transfer, the **property** in goods to a buyer in exchange for **monetary** compensation, called the **price**.

3 (1) It indicates the goods in question, and
(2) It makes provisions for price and quantity of the goods

4 (1) Withdrawal
(2) Revocation
(3) Rejection
(4) Acceptance

5 False. Silence and inactivity cannot be acceptance.

6 A **counter offer** is a reply to an offer which purports to be acceptance but which contains **additional limitations** or other **modifications** to the terms of the offer.

7 (1) Acceptance has not reached the offeror within a fixed timescale (if relevant)
(2) Acceptance has not reached the offeror within reasonable time

8 True. This is also true of an offer.

Now try the questions below from the Exam Question Bank

Number	Level	Marks	Time
Q4	Examination	10	18 mins
Q5	Examination	10	18 mins

5

Obligations and risk in contracts for international sales

Topic list	Syllabus reference
1 Obligations of the seller	B3(a)
2 Buyer's remedies for seller's breach of contract	B3(a)
3 Obligations of the buyer	B4(a)
4 Seller's remedies for buyer's breach of contract	B4(a)
5 Damages	B5(a)(ii)
6 Breach of contract	B5(a)(i)
7 Instalment contracts	B5(a)(i)
8 Interest	B5(a)(iii)
9 Exemptions: unexpected impediment to performance	B5(a)(iv)
10 Effects of avoidance	B5(a)(v)
11 Preservation of the goods	B5(a)(vi)
12 Passage of risk	B5(b)

Introduction

In this chapter we look at the **obligations** of the parties, the **remedies** available when parties default and the issue of when **risk** (for example, the risk of loss or damage to the goods) passes from the seller to the buyer.

The obligations of the seller fall into two key categories, **delivery** and **quality**. Delivery is a particular issue in international contracts, because contracts will often involve carriage, possibly with more than one carrier. Risk is a significant issue when goods are being carried, say at sea, or by more than one party.

If the seller fails to meet his obligations, the buyer may have **remedies**. **Damages** is a remedy common to both the buyer and seller.

The obligations of the buyer and the rights of the seller if the buyer does not meet his obligations are important. The buyer's obligations fall into the categories of **payment**, and **acceptance of delivery**.

We shall also look at the common provisions in relation to **anticipatory breach**, **instalment contracts**, **interest**, **exemption**, **effects of avoidance** and **preservation of goods**.

Study guide

		Intellectual level
B3	**Obligations of the seller**	
(a)	Explain and be able to apply the rules relating to the obligations of the seller under the convention: (i) delivery of goods and handing over documents (ii) conformity of the goods and third party claims (iii) remedies for breach of contract by the seller	2
B4	**Obligations of the buyer**	
(a)	Explain and be able to apply the rules relating to the obligations of the buyer under the convention: (i) payment of the price (ii) taking delivery (iii) remedies for breach of contract by the buyer	2
B5	**Provisions common to both the seller and the buyer, the passage of risk**	
(a)	Explain and be able to apply the rules relating to the provisions common to both the seller and the buyer under the convention: (i) anticipatory breach and instalment contracts (ii) damages (iii) interest (iv) exemptions (v) effects of avoidance (vi) preservation of the goods	2
(b)	Explain and be able to apply the rules relating to the passing of risk under the convention	2

Exam guide

Questions on this chapter are almost bound to crop up in the exam. They can be fairly complex in a scenario question. However the question is styled, you need to know the details of the Convention to answer it effectively.

1 Obligations of the seller

FAST FORWARD

The key obligations of the seller relate to **delivery** and **quality**.

The rules concerning the obligations of the seller are found in Chapter II of Part III of the Convention. There are two key areas for the rules, **delivery**, **quality** and **conformity**. Also in Chapter II are a number of remedies for breach of the rules, and therefore the contract, by the seller.

1.1 Delivery

FAST FORWARD

The seller is required to deliver the goods in **accordance with the contract**, or, if no specifications are made, in accordance with the Convention.

Article 30

The seller must deliver the goods, hand over any documents relating to them and transfer the property in the goods as required by the contract and this Convention: Article 30.

1.1.1 Place of delivery

The terms of the contract between the buyer and seller may **specify a place** where the goods are to be delivered. If so, the goods must be delivered to that place: Article 31.

If the contract does not specify the place, the Convention implies the following terms into the contract:

(a) **Contract involving carriage**

A contract involving carriage is one where the goods have to be transported to the buyer as part of the contract.

The seller discharges his obligation to deliver the goods by handing the goods over to the first carrier for transmission to the buyer. The carrier is the person or entity transporting the goods to the buyer, or to the next carrier, if there are several involved.

(b) **Specific goods/identified goods drawn from specific stock**

If the parties know that the goods are in a particular place at the time the contract is made, then the seller discharges his obligations by placing the goods at the buyer's disposal at that place.

Key terms

Specific goods are those which are identified as the goods to be sold at the time when the contract is made.

Identified goods from specific stock are goods which are not specific but that are part of a larger, specific stock of goods.

(c) **Other instances**

If the contract does not fall into the categories of (a) or (b) then the seller discharges his obligation of delivery if he places the goods at the buyer's disposal at the place where the seller had his business at the time the contract was concluded: Article 31.

1.1.2 Contracts involving carriage

If the **goods in carriage are not clearly identified** to the contract, the seller must give the buyer **notice of the consignment**, specifying the goods: Article 32. The goods could be identified to the contract by markings on the goods, shipping documents or otherwise.

The means of transport chosen by the seller must be reasonable in the circumstances and according to the usual terms of transportation for such goods.

1.1.3 Example

It would not be reasonable, to send perishable goods on a ship when the journey will take 4 weeks.

When the contract involves carriage, the parties will determine which of them should **insure** the goods while in transit. **If the contract does not require the seller to insure** the goods and the **buyer requests information** from the seller so that he may insure the goods, the **seller must give the buyer the available information**: Article 32.

1.2 Time of delivery

FAST FORWARD

Delivery should take place at the **time stated by the contract**.

Delivery should take place **on the date**, or within the period, **specified in the contract**: Article 33.

If the contract specifies a period within which delivery may take place, but makes it clear that the **buyer is entitled to determine** the delivery date, delivery should take place on the date which the buyer determines.

If no date or time period is specified in the contract, delivery should take place within **reasonable time** of the contract being formed: Article 33.

1.2.1 Handing over of documents

If the contract also requires **documents** to be handed over to the buyer by the seller (for example, shipping documents), these should be handed over at the time and place specified by the contract: Article 34.

If the seller hands the documents over **before the required time**, and the documents do not correctly conform to the documents required by the contract, he may correct them before the time specified in the contract for original delivery. This is unless this causes the buyer unreasonable expense: Article 34.

1.3 Quality and conformity

FAST FORWARD

The seller must deliver goods which are of the **quantity**, **quality** and **description** required by the contract and that are contained or packaged in the manner required by the contract.

Article 35

The seller must deliver goods which are of the quantity, quality and description required by the contract and which are contained or packaged in the manner required by the contract: Article 35.

If the contract does not state what the required level of quantity and quality is and the goods are not described in the contract, the following **conformity requirements** must be met.

1.3.1 Conformity requirements

Conformity requirements: : Article 35(2)
The goods are **fit for the purposes** for which **goods of the same description** would **ordinarily be used**.
The goods are fit for **any particular purpose expressedly or impliedly made known to the seller at the time of forming the contract**. This is unless circumstances show that the buyer did not rely, or that it was unreasonable to rely on the seller's skill and judgement.
The goods **possess the qualities of any sample or model** held out by the seller to the buyer.
The goods are **contained or packaged in the manner usual for such goods**, or where there is no such manner, in a manner adequate to preserve and protect the goods.

The seller is **not** obliged under Article 35(2) to sell goods which conform to all statutory or other public provisions in force in the buyer's state (such as health and safety regulations) unless either:

(a) The same provisions apply in the seller's state, or
(b) The buyer told the seller about the provisions and then relied on the seller's expert knowledge, or
(c) The seller knew of the provisions due to special circumstances.

UN Case 84

The facts: The seller, a Swiss company, sold New Zealand mussels to the buyer, a German company. The buyer refused to pay because the mussels had been found by the Federal Health Office to be unsafe because they contained a cadmium concentration in excess of the statutory limit.

Decision: The supply of mussels with higher cadmium composition did not constitute a fundamental breach of contract justifying avoidance of the contract and a refusal of the buyer to pay the purchase price. The high cadmium composition did not constitute lack of conformity of the mussels with contract specifications under CISG 35(2), and the mussels were still fit for eating. It was also held that, even if the buyer had established faulty packaging of the goods as it had tried to do, the contract could not be avoided. In order to justify avoidance of the contract in these circumstances, faulty packaging must be a fundamental breach of contract, and must be easily detectable. This would enable the buyer to declare avoidance of the contract within a reasonable time after receiving delivery. The buyer was ordered to pay the purchase price plus interest.

The **seller is not liable for a lack of conformity** in the goods **if**, at the time of forming the contract, the **buyer knew**, or could not have been unaware, that the goods did not conform: Article 35(3).

The **seller is liable for any lack of conformity** which exists at the time when risk passes to the buyer, even through the lack of conformity becomes apparent only after that time: Article 36(1). The seller is also liable for any lack of conformity which occurs after risk passed and which is due to a breach of any of his obligations. This includes a breach of any guarantee that for a period of time the goods will remain fit for their ordinary purpose or for some particular purpose, or will retain specified qualities or characteristics: Article 36(2).

When the seller has delivered goods before the date for delivery but there is a shortfall of quantity or some other **non-conformity**, he may deliver any missing part or make up any deficiency up until the agreed date for delivery. This is provided it does not cause the buyer unreasonable expense or inconvenience. In such cases, the buyer may still seek damages: Article 37.

1.3.2 Buyer's duty to examine the goods

The buyer must examine the goods to ensure conformity as soon as possible after delivery: Article 38.

(a) If the contract involves **carriage**, he should examine the goods as soon as possible after their arrival.

(b) If the goods are being **despatched immediately by the buyer** and the seller knows that, the goods may be examined on their arrival at the next destination: Article 38.

The buyer loses the right to rely on a **lack of conformity** of the goods **if he does not give notice to the seller** specifying the lack of conformity **within a reasonable time** after he has discovered it or ought to have discovered it: Article 39. If he does not inform the seller within two years of goods being handed over, the right is usually lost: Article 39.

UN Case 48

The facts: A German buyer of fresh cucumbers wanted to obtain a reduction of the price because the goods did not conform with contract specifications.

Decision: The court of first instance dismissed the application because the buyer had inspected the goods at the place of delivery in Turkey and had found them to be in good order. The appellate court found that the UN Convention was applicable as part of German law and it upheld the decision of the first court. The buyers had lost the right to rely on non-conformity because they waited 7 days, until the goods arrived in Germany to give notice of the non-conformity.

The seller cannot rely on Articles 38 and 39 to relieve him of responsibility regarding lack of conformity if the lack of conformity relates to facts of which he **knew or could not have been unaware**, and which he did not disclose to the buyer: Article 40.

1.4 Third party rights

FAST FORWARD

The Convention sets out the position regarding third party rights to goods, especially with regard to **intellectual property**.

Article 41

The seller must deliver goods which are free from any right or claim of a third party, unless the buyer agreed to take the goods subject to that right or claim. However, if such right or claim is based on industrial property or other intellectual property, the seller's obligation is governed by article 42.

Article 42

The seller must deliver goods which are free from any right or claim of a third party based on industrial property or other intellectual property, of which at the time of the conclusion of the contract the seller knew or could not have been unaware, provided that the right or claim is based on industrial property or other intellectual property:

(a) Under the law of the State where the goods will be resold or otherwise used, if it was contemplated by the parties at the time of the conclusion of the contract that the goods would be resold or otherwise used in that State; or

(b) In any other case, under the law of the State where the buyer has his place of business.

Key term

Intellectual property is a term covering a number of distinct rights which provide the owner with a form of limited monopoly or a degree of exclusivity.

Intellectual property includes:

- Trade marks
- Patents
- Copyright

In other words, if the goods are subject to such a right or claim, the buyer must have **agreed** that he is to receive goods subject to such claims.

Notice that the qualification is that the buyer **must have been aware**, or **could not have been unaware of the right to claim**. An arbitral tribunal might conclude that a party could not have been unaware of a global branding feature, such as the Coke dynamic ribbon. The seller is also relieved from liability where the right or obligation results from the seller's compliance with technical drawings, designs, formulae or other such specifications made by the buyer: Article 42.

The buyer must notify the seller of third party rights and claims within a **reasonable time** of becoming aware of it: Article 43. This does not apply if the seller is already aware of the claim.

2 Buyer's remedies for seller's breach of contract

FAST FORWARD

If the **seller breaches the contract**, the buyer has the right to: **require performance**; **declare** the **contract avoided**; **reduce the price** in proportion to the non-conformity; **seek damages**.

Key terms

Breach of contract is **where a party fails to perform his obligations** under the contract.

Fundamental breach of contract is where a breach results in such detriment to the other party so as to substantially deprive them of what they are entitled to expect under the contract. This is unless the party in breach did not foresee such a result, and a reasonable person in the same kind of circumstances would not have foreseen it: Article 25.

The buyer is given a number of **rights** under the Convention if the seller breaches the contract. These fall into two categories:

- Specific rights given in the Convention
- Damages (we shall discuss damages in Section 5, as they apply to both the seller and the buyer)

2.1 Specific rights of the buyer under the Convention

The buyer is given a number of rights in articles 46 – 52 of the Convention.

- Article 46: Right to require performance
- Article 49: Right to declare the contract avoided
- Article 50: Right to reduce price in relation to non-conformity of goods

When only part of the goods have been delivered, or only part of them are in conformity, Articles 46–50 apply to the undelivered or non-conforming parts: Article 51.

Point to note

Remember that the exercise of any of these rights **does not exclude the buyer's right to claim damages**: Article 45.

2.2 Performance

The buyer may require **performance of the contract** by the seller: Article 46.

The buyer may not require the seller to perform if he has already resorted to remedy that is **inconsistent** with performance (for example, declaring the contract avoided, see below).

The buyer may set an **additional period of time** for the contract to be performed in: Article 47. If he does so, he may not resort to another remedy for breach in that additional time period. Of course, as stated above, he is still entitled to make a claim for damages after the additional time period.

Note that a court does not have to enter a judgement of **specific performance** against any party unless it would do so in local cases under the law of its own contracting state: Article 28.

2.2.1 Lack of conformity of the goods

If the goods delivered by the seller do not conform to the contract or Convention requirements, the buyer may require the seller to:

(a) Deliver **substitute goods** (if the breach of that term of the contract was fundamental).

(b) **Repair the goods** (if the lack of conformity is slight, and the request to repair is not unreasonable): Article 46.

Subject to the remedy of avoidance, below, even after the date for performance the **seller may remedy** his own **failure to perform** at his own expense under Article 48 if:

- There is no unreasonable delay.
- It does not cause the buyer unreasonable inconvenience or uncertainty as to whether expenses advanced to the seller by the buyer will be reimbursed: Article 48.

In order to take such action, the seller should **give notice to the buyer** of his intentions. This notice is **deemed** to **include a request** that the buyer should contact the seller to let him know whether late performance is **acceptable**. This deemed notice is only effective if the buyer receives it.

If the buyer receives the deemed notice and does not reply, the seller can assume that this means the late performance is acceptable and carry on with his **performance**.

Remember that the buyer retains the right to claim **damages**.

2.2.2 Early delivery

If the seller delivers the goods early, the buyer may take delivery or refuse to take delivery at that time: Article 52.

2.2.3 Excess delivery

If the seller delivers more than was ordered, the buyer may take delivery of some or all of the excess, or not, as he chooses: Article 52. If he does accept additional goods however, **he must pay for them** at the contract price.

2.3 Avoidance

The buyer may declare the contract avoided if a failure by the seller to perform is a **fundamental breach of contract**: Article 51, they may also declare the contract avoided, in case of non-delivery, if the seller does not deliver in the additional time period fixed by the buyer, or declares that he will not be able to deliver in a fixed time period: Article 49. A declaration of avoidance is effective only if made by notice to the other party: Article 24.

2.3.1 Example: fundamental breach of contract

Failure to perform might be a fundamental breach of contract in a contract where time is of the essence. For example, when the goods are needed at a certain stage in the buyer's production, or for a particular point in time.

The buyer **loses the right to declare a contract avoided** if the goods are delivered, unless:

(a) Delivery is late (and he does so within a reasonable time of discovering the goods have been delivered).

(b) The seller commits another breach of contract (and he does so within a reasonable time after he knew or ought to have known of the breach, and after any additional time periods fixed): Article 49.

2.4 Reduction of the price

If the goods do not conform to the requirements of the contract (see conformity of the goods in Section 1), the **buyer is entitled to reduce the price in proportion to the lack of conformity**. This is unless the seller corrects the lack of conformity in the contract time period or the buyer refuses to accept correction which is in line with Articles 37 and 48: Article 50. In the following case, the seller did not correct within the time period, and was not entitled to do so after that time period.

UN Case 56

The facts: A Swiss retailer refused to pay the seller, an Italian manufacturer of furniture, the purchase price, claiming that the goods did not conform to the contract.

Decision: The court held that as the buyer has resold some of the goods without notifying the seller in time about that resale, the buyer had lost its right to rely on the non-conformity of those goods. However, with regard to the rest of the goods, the buyer was granted a reduction in the price as he had notified the seller of the defects promptly and the seller had refused to remedy them. The seller offered to pay the repair costs instead, but the court held that the intention of the convention was not to cover repair costs. It was to reduce the purchase price in relation to what value the delivered goods had in comparison to the value that conforming goods would have had.

The buyer may also reduce the price if the buyer has a reasonable excuse for failing to give notice of third party rights under Article 43: Article 44.

3 Obligations of the buyer

FAST FORWARD

The buyer has obligations in respect of **taking delivery of the goods and making payment**.

The rules concerning the obligations of the buyer are found in Chapter III of Part III of the Convention. There are two key areas for the rules, **payment** and **taking receipt of delivery**. Also in Chapter III are a number of remedies for breach of the rules, and therefore the contract, by the seller.

3.1 Payment

Article 53

The buyer must pay the price for the goods and take delivery of them as required by the contract and this Convention: Article 53.

This general requirement includes a duty to take steps to **comply with any formalities** to enable to payments to be made: Article 54.

The following provisions also apply:

(a) **Price not concluded**: Where the contract has been formed without reference to the price, the buyer and seller are deemed to have, by implication, made reference to the price generally charged at the time the contract was formed: Article 55.

(b) **Price determined accorded to weight**: Where the price is to be fixed according to weight, if there is doubt, the price is to be determined by net weight: Article 56.

3.1.1 Where price is to be paid

The contract may specify where the price is to be paid. If it does not, the buyer must:

- Pay it at the seller's place of business, or
- If payment is to be made when goods or documents are handed over, at the place **where the goods or documents are handed over**: Article 57

If the seller changes his place of business after the contract has been formed, and it costs the buyer more to make payment as a result, the seller should bear that increase in price: Article 57.

3.1.2 When the price is to be paid

The contract may specify when the price is to be paid. If it does not, the buyer must pay the price when the seller places the goods and/or documents at the buyer's disposal, although:

- The buyer is **not obliged** to pay until he has **examined** the goods. This is unless the procedures for delivery or payment agreed upon by the parties are inconsistent with the buyer having that opportunity
- The seller may make payment a **condition** of handing over the goods
- If the contract includes **carriage**, the seller may **despatch** the goods on the condition that they will not be released unless **payment is made**: Article 58

If a fixed date for payment has been set, the buyer must pay the price without the seller needing to request that he does so: Article 59.

3.2 Taking delivery

The **buyer's obligation** to take delivery consists of the buyer:

- Doing all acts which could reasonably be expected of him in order to enable the seller to make delivery
- Taking over the goods: Article 60

4 Seller's remedies for buyer's breach of contract

FAST FORWARD

If the buyer breaches the contract the seller has the right to: require **payment** and **acceptance** of the goods; **declare** the **contract avoided**; **seek damages**.

The seller is given a number of **rights** under the Convention by Article 61 if the buyer breaches the contract. These fall into two categories:

- Specific rights given in the Convention in Articles 62 to 65
- Damages (we shall discuss damages in Section 5 below, as they apply to both the seller and the buyer)

If a seller seeks a remedy for breach of contract the court may not grant the buyer any period of grace: Article 61.

4.1 Specific rights under the Convention

The seller is given a number of rights in Articles 61–65 of the Convention.

(a) Article 62: Right to require payment and acceptance of goods
(b) Article 64: Right to declare the contract avoided

Point to note

Remember that the exercise of any of these rights does not exclude the seller's right to claim damages: Article 61.

4.2 Right to require payment and acceptance of the goods

The **seller has the right to require the buyer to make payment, take delivery or perform his other obligations**, unless he has resorted to a remedy which is incompatible with this: Article 62.

The seller may fix an **additional time period** within which the buyer should perform his obligations: Article 63. This should be of **reasonable** length. The seller may not resort to any remedy for breach of contract during this time period. The seller is not deprived however of the right to claim damages for delay in performance.

4.3 Avoidance

The seller may declare the contract avoided:

- If the buyer's failure to perform is a fundamental breach; or
- If the **buyer does not accept the goods** and/or **pay for them** in the additional time period allowed by the seller; or
- The buyer **declares that he will not accept the goods and pay for them** in that time: Article 64.

Where the buyer has paid for the goods, the seller loses the right to declare it avoided, unless he does so:

- In respect of **late performance** buy the buyer, before the seller becomes aware that performance has been rendered.
- In respect of **any other breach** by the buyer, within a reasonable time of knowing of the breach, or in the expectation of additional time allowed: Article 65.

4.4 Buyer's failure to specify

The contract may state that the buyer is to specify the **form**, **measurement** or other **features** of the goods. If he fails to do so, the seller may make the specification, taking into account the buyer's known requirements: Article 65. He must inform the buyer of this and fix a reasonable time by which the buyer can make amendments. Further failure by the buyer to act means that the seller's specification is binding.

5 Damages

FAST FORWARD

An injured party is **always entitled to claim damages** under the Convention, regardless of any other remedy sought or obtained, though he is required to **mitigate** (seek to limit) the extent of his loss made. Damages is a monetary remedy equal to the **loss suffered by the injured party** as a result of the breach.

Exam focus point

Damages is a key remedy and you must be able to explain it in an exam. Remember that **injured party** is **always entitled to claim damages**, **regardless** of any **other claims** he makes under the Convention.

Key term

Damages is a monetary sum equal to the loss (including loss of profit) suffered by the injured party as a consequence of the breach: Article 74.

The **amount** of damages may not be greater than the loss which the party in breach foresaw (or should have foreseen) at the time of the contract being formed, in the light of known facts then.

If the buyer has avoided the contract for the seller's breach and has bought **replacement goods** he may claim the value of these as damages: Article 75.

If the seller has avoided the contract for the buyer's breach, and has sold the goods to another party, the **proceeds of this sale** should be deducted from any damages awarded: Article 75.

If the contract is avoided and there is a current price for the goods, the party claiming damages may, if he has not made a purchase or resale, recover the difference between the price fixed by the contract and the current price at the time of avoidance, as well as any further damages recoverable.

However, if the party claiming the damages has avoided the contract after taking over the goods, the current price at the time of such taking over shall be applied instead of the current price at the time of avoidance: Article 76.

The 'current price' is the price prevailing at the place where delivery of the goods should have been made or, if there is no current price at that place, the price at such other place as serves as a reasonable substitute, making due allowance for differences in the cost of transporting the goods.

5.1 Mitigation of the loss

Article 77 requires an injured party to take **reasonable measures** to mitigate the loss, including loss of profit, resulting from the breach.

Examples of mitigation include:

- Selling goods rejected by the buyer to a **third party**
- Buying **replacement goods** from a third party when the seller has failed to deliver

If a party fails to mitigate his loss, damages may be **reduced** by the amount in which the loss should have been mitigated: Article 77.

The following English case illustrates the operation of the doctrine of mitigation of loss.

Payzu Ltd v Saunders 1919

The facts: The parties had entered into a contract for the supply of goods to be delivered and paid for by instalments. The claimants failed to pay for the first instalment when due, one month after delivery. The defendants declined to make further deliveries unless the claimants paid cash in advance with their orders. The claimants refused to accept delivery on those terms. The price of the goods rose, and they sued for breach of contract.

Decision: The seller had no right to repudiate the original contract. But the claimants should have mitigated their loss by accepting the seller's offer of delivery against cash payment. Damages were limited to the amount of their assumed loss if they had paid in advance, which was interest over the period of pre-payment.

6 Breach of contract

FAST FORWARD

A party may **suspend performance** if he has reason to believe that the other party will not perform a substantial part of the contract. A party suspending performance should give notice to the other party, and if the other party assures performance, the suspension should not be carried out. In cases of **fundamental breach**, the contract may be **avoided**.

Attention!

Remember, **breach of contract** is defined as the failure of one party to perform their obligations under the contract.

6.1 Anticipatory breach: suspension of performance

The Convention gives parties the right to **suspend performance** in certain situations. The general rule is as follows: a party may suspend performance if, after the contract starts, it becomes apparent that the other party will not perform a substantial part of his obligations due to:

- A serious deficiency in his ability to perform, or his creditworthiness
- His conduct in preparing to perform/performing the contract: Article 71

What this means is that a party may suspend performance if the other party is in **anticipatory breach**. In other words, it is clear that the party will breach the contract, even if the time for performance has not arrived.

In order to suspend performance in this way, the person suspending performance must give the other party **notice** of his actions. If the other party gives adequate **assurance** that they are going to perform the contract, then the suspending party must **not suspend performance**, but must **carry on** with it: Article 71.

If the seller has already dispatched the goods before grounds for believing the buyer will be in anticipatory breach become evident, he may **prevent the goods being handed over** to the buyer. This may be even though the buyer holds documents of title: Article 71.

6.2 Fundamental breach: avoidance of the contract

If it becomes clear that the other party is going to commit a fundamental breach of contract, the other party may **declare the contract avoided**: Article 72. If time allows, he must give reasonable notice of avoiding the contract in order to give the other party time to provide adequate assurance of performance. This is unless the other party has declared that he will not perform his obligations: Article 72.

Exam focus point

Breach of contract is easily examined by a ten-mark knowledge question. Be prepared to explain fundamental or (as in December 2008) anticipatory breach.

7 Instalment contracts

FAST FORWARD

Failure to perform an **instalment** of a contract may allow the other party to avoid that instalment or the whole contract.

It may be that the contract is set up to be in **instalments** (of delivery or payment) under Article 73.

If a party fails to perform his obligations in relation to any instalment and this causes the instalment or whole contract to be fundamentally breached, the other party has certain rights. They may declare the contract **avoided** with respect to that instalment (Article 73(1)) **or** in respect of the whole contract (Article 73(2)). The latter is the case where failure to perform one instalment gives the other party a reasonable basis to assume the rest of the contract won't be fulfilled. The party may declare the contract avoided in respect of future deliveries if they do so within a reasonable time: Article 73(2). If deliveries are interdependent and so the purpose contemplated when the contract was formed is frustrated the contract may also be avoided: Article 73(3).

8 Interest

FAST FORWARD

A party who fails to pay the price or any sum in arrears will be required to pay **interest** on the overdue sum at a statutory rate.

If a party fails to pay the price or any sum that is in arrears, the other party is entitled to receive **interest on that overdue sum**: Article 78. This interest would be at an applicable statutory rate, and would not prejudice any claim for damages.

9 Exemptions: unexpected impediment to performance

FAST FORWARD

Parties are not liable for non-performance due to **unexpected impediments** out of their control.

A party to an international contract is **not** liable to pay damages for a failure to perform any of their obligations if they can prove that the failure was due to an **impediment beyond their control**: Article 79(1). They must also show that they could not **reasonably have been expected to have taken the impediment into account at the time** of the conclusion of the contract, or to have avoided or overcome the impediment or its consequences. The exemption from liability only has effect for the period during which the impediment exists: Article 79(3).

Sometimes the party who suffered the impediment did so because of a failure by a third party (sub-contractor) whom they had engaged to perform the whole or part of the contract's obligations. In this case, the party is only exempt from liability under Article 79(2) if they can prove that both they themselves and the sub-contractor would be exempt under the terms of Article 79(1).

Where a party who fails to perform because of an impediment wishes to benefit from exemption under Article 79, they must give **notice** of the impediment to the other party and its effect on their ability to perform. However, this notice must be received by the other party within a reasonable time after the defaulting party knew or ought to have known of the impediment. If there is delay in this respect then the defaulting party is liable for damages resulting from the injured party's non-receipt of notice: Article 79(4).

Article 79 affects **only the parties' rights in respect of damages** under the Convention; any other right available under the Convention, such as reduction of the price, is unaffected by Article 79: Article 79(5).

If one party's **act or omission** causes failure of the other party to perform, the first party may not rely on the second party's failure to perform: Article 80.

10 Effects of avoidance

FAST FORWARD

Avoidance of the contract releases both parties from their obligations, but does not affect the parties' rights to apply for damages, any provisions for the settlement of disputes or the ability to claim restitution.

Avoiding the contract releases both parties from their obligations under the contract: Article 81. This does not affect:

- The parties' right to make a claim for **damages**
- Any provisions in relation to the **settlement of disputes**
- Any other provisions in the contract governing the parties' rights and obligations in the event of avoidance
- The right to claim **restitution of the goods** by a party who has performed the contract wholly or in part

You should note that the right to avoid the contract is lost if **restitution of the goods cannot take place** (for example, if they have been sold on to a third party): Article 82. The buyer can still claim damages: Article 83. When both parties are bound to make restitution, they must do so concurrently.

However, despite impossibility of restitution, one party may still avoid the contract or require delivery of substitute goods if:

- The impossibility of restitution is not due to his act or omission,
- The goods have deteriorated or perished because of examination by the buyer, or
- The goods have been sold, consumed or transformed by the buyer before he discovered their lack of conformity: Article 82.

When the buyer cannot claim restitution or avoid the contract, but has paid the price, the seller must refund the price plus interest: Article 84. Whether or not he makes restitution of the goods, the buyer must account to the seller for all benefits he has derived from the goods: Article 84.

11 Preservation of the goods

FAST FORWARD

Both parties have a duty to take reasonable steps to **preserve the goods** when they are in their possession.

Both parties have a duty to take reasonable steps to **preserve the condition of goods** belonging to the **other party** which are in their possession. In some cases, if the only reasonable step to take is to sell the goods to a third party and realise their value, both parties may take this step if they have given notice to the other party. The duty falls particularly on the parties in the following situations:

ARTICLE 85

- Buyer delays taking delivery
- Delivery and payment were to be concurrent but payment has not taken place

Seller must take reasonable steps to preserve the goods, and retain them until expenses have been reimbursed

ARTICLE 86

- Buyer receives goods but intends to reject them
- Goods have been dispatched to the buyer and placed at his disposal but he has rejected them

Buyer must take reasonable steps to preserve the goods and retain them until expenses have been reimbursed, unless he has agreed to pay the price or take on unreasonable expense

If the seller or his agent is not present, the buyer must take possession of the goods on behalf of the seller even if he intends to reject

However, in this situation, he may store the goods in a third party warehouse at the seller's expense in order to preserve them: Article 87.

A party who is bound to preserve the goods as above may **sell** them by any appropriate means. They can do this if there has been an unreasonable delay by the other party in taking possession of the goods, in taking them back, or in paying the price or the cost of preservation, provided that reasonable notice of the intention to sell has been given to the other party: Article 88.

Where goods are subject to rapid **deterioration**, or their preservation would involved **unreasonable expense**, the party **must** take reasonable measures to sell them, and to give notice of this to the other party if possible. Any party selling goods in these circumstances can retain amounts from the proceeds of sale to cover **preservation and selling expenses**, but must account for the balance to the other party: Article 88.

Question

Outline the situation in which the buyer has a particular duty to preserve the goods under the UN Convention on Contracts for the International Sale of Goods.

Answer

The buyer has a particular duty to ensure the preservation of goods in the following circumstances:

- He has received the goods but intends to reject them
- The goods have been despatched to him but he has rejected them

12 Passage of risk

FAST FORWARD

In contracts **involving carriage**, if not otherwise specified by the parties, risk passes to the buyer **when the goods are given to the first carrier**. In contracts **not involving carriage**, if not otherwise specified by the parties, risk passes to the buyer **when he takes over the goods**.

Article 66

Loss of or damage to the goods after risk has passed to the buyer does not discharge him from his obligation to pay the price, unless loss or damage is due to an act or omission of the seller: Article 66.

A key issue for parties to contracts for sales of goods is **'when does risk pass?'** In other words, when does the risk of loss or damage to the goods pass from the seller to the buyer?

Exam focus point

This very point was the subject of an exam question in June 2008.

The answer falls into three parts, depending on whether the contract includes **carriage** or not and whether the goods are sold when already in transit.

12.1 Contract including carriage

The **contract may specify the place** at which risk passes to the buyer. If it does, then the **risk passes** to the buyer **when the goods are transferred to the carrier at that place** (even if the seller is authorised to retain documentation at that time): Article 67.

If the **contract does not specify** the place at which risk passes to the buyer, then **risk passes** when the **goods are transferred to the first carrier** for transmission to the buyer: Article 67.

However, in either case, **risk does not pass** to the buyer **unless** the **goods are clearly identified** to the contract, by markings, shipping documents, notice or otherwise.

12.2 Contracts for goods sold in transit

Goods may sometimes be sold when they have already been put in transit from the place of manufacture (say, Korea) to some distribution centre (say, Hamburg). The risk in goods sold in transit passes to the buyer from the time the contract is concluded. This is when the circumstances are such that the risk is assumed by the buyer from the time the goods were handed over to the carrier who issued the documents embodying the contract of carriage. Nevertheless, if at the time of the conclusion of the contract of sale the seller knew or should have known that the goods had been lost or damaged and did not tell the buyer, the seller keeps the risk: Article 68.

12.3 Contracts not including carriage

Risk passes to the buyer when he takes over the goods, or the goods are **placed at his disposal** and he commits breach by not taking delivery of them: Article 69.

If the buyer is bound to take over the goods at a place **other than the seller's place of business**, risk passes to the buyer when delivery is due and the **buyer is aware** that the **goods have been placed at his disposal**: Article 69. When the seller has committed a fundamental breach of contract the rules on risk in Articles 67-69 do not affect the buyer's remedies for breach: Article 70.

12.4 Risk and non-conformity of the goods

If the goods do not conform to the required standards of quality, quantity and description, as discussed in Section 2, and this is not discovered until after risk has passed to the buyer, the seller is still liable for this lack of conformity if it is due to a breach of his obligations: Article 36.

Question — Obligations and breaches

(a) Pat Co contracted with Arial Inc that Arial Inc would deliver 100 metal bars to Pat Co on 20 August 20X3. Arial Inc will ship the goods to Pat Co. The ship is supposed to leave on 16 August and is due to dock in Pat Co's country in 19 August. Outline the situation between the parties if the ship was delayed at sea, and did not arrive in Pat Co's country until 21 August.

(b) Daily SA formed a contract with Cheshire plc for the sale of 100,000 plastic parts. Daily has delivered the goods on time, but on examining the goods, Cheshire has rejected them due to non-conformity with contract specifications.

Required

Discuss the situation between the parties in each of the scenarios above.

Answer

(a) **Pat Co and Arial Inc**

In a contract involving carriage, the seller discharges his obligation to deliver the goods when he passes them to the first carrier. Thereafter the goods are at the risk of the buyer.

Arial Inc will therefore discharge its obligations in respect of delivery to Pat Co when it passes the goods to the first carrier, regardless of the delay subsequent to that.

However, Pat Co will be entitled to check the goods on arrival to ensure that they conform to the contract specifications, so technically, Arial Inc has not discharged its obligation in respect of quality until then.

Pat Co will therefore have no recourse against Arial Inc in respect of delivery, and unless the goods do not conform, will be required to accept the goods and pay the price.

(b) **Daily SA and Cheshire plc**

Daily appears to have discharged its obligation to deliver the goods. Cheshire is obligated to accept and pay for the goods. However, it appears that Daily may have failed to discharge its obligation of quality, as the goods do not conform to contract specifications. Cheshire must give notice to Daily that the goods do not conform, within a reasonable time.

If the parties are still within the original contract time-frame, Daily may be able to correct the goods so that they do conform. Otherwise, Cheshire can require Daily to provide substitute goods (if the breach is fundamental to the contract) or repair the goods at Daily's own expense.

If Daily does not correct the lack of conformity, Cheshire is entitled to reduce the price in proportion to the lack of conformity.

Chapter Roundup

- The key obligations of the seller relate to **delivery** and **quality**.
- The seller is required to deliver the goods in **accordance with the contract**, or, if no specifications are made, in accordance with the Convention.
- **Delivery** should take place at the **time stated by the contract**.
- The seller must deliver goods which are of the **quantity**, **quality** and **description** required by the contract and that are contained or packaged in the manner required by the contract.
- The Convention sets out the position regarding third party rights to goods, especially with regard to **intellectual property**.
- If the **seller breaches the contract**, the buyer has the right to: **require performance**; **declare** the **contract avoided**; **reduce the price** in proportion to the non-conformity; **seek damages**.
- The buyer has obligations in respect of **taking delivery of the goods and making payment**.
- If the buyer breaches the contract, the seller has the right to: require **payment** and **acceptance** of the goods; **declare** the **contract avoided**; **seek damages**.
- An injured party is **always entitled to claim damages** under the Convention, regardless of any other remedy sought or obtained, though he is required to **mitigate** (seek to limit) the extent of his loss made. Damages is a monetary remedy equal to the **loss suffered by the injured party** as a result of the breach.
- A party may **suspend performance** if he has reason to believe that the other party will not perform a substantial part of the contract. A party suspending performance should give notice to the other party, and if the other party assures performance, the suspension should not be carried out. In cases of **fundamental breach**, the contract may be **avoided**.
- Failure to perform an **instalment** of a contract may allow the other party to avoid that instalment or the whole contract.
- A party who fails to pay the price or any sum in arrears will be required to pay **interest** on the overdue sum at a statutory rate.
- Parties are not liable for non-performance due to **unexpected impediments** out of their control.
- **Avoidance** of the contract releases both parties from their obligations, but does not affect the parties' rights to apply for damages, any provisions for the settlement of disputes or the ability to claim restitution.
- Both parties have a duty to take reasonable steps to **preserve the goods** when they are in their possession.
- In contracts **involving carriage**, if not otherwise specified by the parties, risk passes to the buyer **when the goods are given to the first carrier**. In contracts **not involving carriage**, if not otherwise specified by the parties, risk passes to the buyer **when he takes over the goods**.

Quick Quiz

1 **Fill in the blanks**.

………………… …………. are those goods which are identified as the goods to be sold at the time when the contract is made.

2 What are the four minimum conformity requirements set out in the Convention?

(1) ....

(2) ....

(3) ....

(4) ....

3 If the seller delivers goods which do not conform to the contract specifications, the buyer always has the right to demand substitute goods.

True ☐

False ☐

4 When the contract does not refer to price, the buyer and seller are deemed to have made reference to the price generally charged at the time the contract was formed.

True ☐

False ☐

5 What does the buyer's obligation to take delivery consist of?

(1) ....

(2) ....

6 **Fill in the blanks**.

A party may suspend performance if, after the contract starts, it becomes apparent that the other party will not perform a ……………………… part of his obligations because of:

A ……….. …………… in his ability to perform or creditworthiness

His ……………… in preparing to perform the contract

7 A party is entitled to interest on the price if it is not paid on time.

True ☐

False ☐

8 In what circumstances does the seller have a duty to take reasonable steps to preserve the goods?

(1) ....

(2) ....

9 Zinc and Copper have formed a contract for the sale of goods involving carriage. When will the risk attached to the goods pass from Zinc (seller) to Copper (buyer)?

Answers to Quick Quiz

1 **Specific goods** are those goods which are identified as the goods to be sold at the time when the contract is made.

2 (1) Fit for the purpose for which goods of that description would ordinarily be used
(2) Fit for any purpose express or implied to the seller at the time of the contract
(3) Possess qualities of any sample or model used to obtain the sale
(4) Contained/packaged in a manner usual for such goods

3 False. If the lack of conformity is minor, the seller may repair the goods.

4 True. The price generally charged at the time the contract was formed will apply if a contract does not refer to a price.

5 (1) Doing all acts that could reasonably be expected of him to take delivery
(2) Taking over the goods

6 A party may suspend performance if, after the contract starts, it becomes apparent that the other party will not perform a **substantial** part of his obligations because of:

- A **serious deficiency** in his ability to perform or creditworthiness
- His **conduct** in preparing to perform the contract

7 True. Interest is payable if the price is not paid on time.

8 (1) The buyer delays taking delivery
(2) The payment and delivery were due to be concurrent, but the buyer has not made payment

9 When Zinc passes the goods to the first carrier, the risk passes to Copper.

Now try the question below from the Exam Question Bank

Number	Level	Marks	Time
Q6	Examination	10	18 mins

Transportation and payment

6

Topic list	Syllabus reference
1 Bills of lading	B6(a)
2 Means of payment	B7(a-c)
3 International bank transfers	B7(a)(i)
4 UN Model Law on International Credit Transfers	B7(b)
5 Bills of exchange	B7(a)(ii)
6 UN Convention on International Bills of Exchange and International Promissory Notes	B7(c)
7 Letters of credit	B7(a)(iii)
8 Letters of comfort	B7(a)(iv)

Introduction

In this chapter we shall look at some practical issues relating to transportation and payment.

We have made reference in previous chapters to the importance of carriage in an international sale of goods contract. Here we shall look at the issue of transportation documents, specifically **bills of lading**. These are documents issued by the physical carrier of the goods to the person with whom the shipper has contracted to transport the goods.

When contracts for the international sale of goods have been concluded, as we have seen in the previous chapter, **payment of the price** must take place. Making payments internationally is more complicated than making payments within your own country. For example, a British cheque will not be acceptable to an American supplier

However, increasing globalisation of banks and banking methods means that making **international payments** is more straightforward than it has ever been. We shall look at three methods; **bank transfers**, **bills of exchange** and **letters of credit**.

UNCITRAL has treaties in existence setting out international law for the use of **credit transfers** and **bills of exchange** which we shall cover.

Study guide

		Intellectual level
B6	**Transportation documents**	
(a)	Define and explain the operation of bills of lading	1
B7	**Means of payment**	
(a)	Explain the operation of: (i) Bank transfers (ii) Bills of exchange (iii) Letters of credit (iv) Letters of comfort	1
(b)	Explain and be able to apply the rules of UNCITRAL Model Law on International Credit Transfer	2
(c)	Explain and be able to apply the rules of United Nations Convention on International Bills of Exchange and International Promissory Notes	2

Exam guide

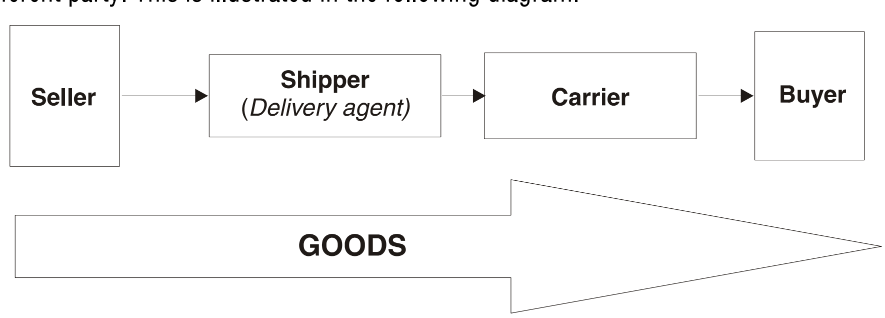
Transportation documents and payment are probably most likely to be examined knowledge questions, but there is nothing stopping the issues in this chapter from cropping up in scenario questions in the exam.

1 Bills of lading

FAST FORWARD

Carriage is an important feature of international contracts for the sale of goods. The **bill of lading** is therefore an important document because it is evidence of when the goods have passed to the carrier. This is a sign that risk has passed to the buyer, unless the parties have agreed otherwise.

We have already mentioned the importance of **carriage** in a sale of international goods. Goods will usually be transported to the buyer by a third party, a courier or shipping company. This may be **complicated** by the fact that delivery is obtained through one third party and subcontracted or otherwise carried out by another different party. This is illustrated in the following diagram.



FAST FORWARD

Bills of lading may be **negotiable** or **non-negotiable**, and they may take the form of an inland, ocean or through bill of lading, or an airway bill.

An important document associated with the transfer of goods from the buyer to the seller in this arrangement is a **bill of lading**.

Key term

> A **bill of lading** is a document which is issued by a carrier to the shipper acknowledging that the carrier has received the shipment of goods and that they have been placed on board a particular vessel, bound for a particular destination.

The bill of lading does three things:

(a) It provides **evidence** that the goods described in it have been **received by the carrier** (and, if it is a shipped bill of lading, that they have been shipped)

(b) It either provides evidence of, or contains within it, the **contract of carriage** and the terms on which the goods are to be carried

(c) It can be a **document of title** to the goods being shipped

It will also usually state **to whom the goods are being shipped**. The seller is responsible for ensuring that a bill of lading is delivered to the buyer with the goods.

The bill of lading is important when you consider the **passing of risk** under the contract, that we discussed in the previous chapter. You will remember that if no other provision is made, **risk passes to the buyer when the goods pass to the carrier**. The **bill of lading is evidence that that has happened**, so it is evidence of when risk passes to the buyer.

A bill of lading may be one of four types:

(a) An **inland bill of lading** relates to a contract for transporting goods overland to the seller's international carrier (say, from the factory to the port)

(b) An **ocean bill of lading** relates to a contract for carriage of goods from a seller in one country to a specified port in another country

(c) A **through bill of lading** combines the contracts for inland and marine carriage. It covers transport from one specified point to another

(d) An **airway bill** relates to a contract for carriage of goods by air (both domestic and international) from one point to another

A **very important distinction** between types of bills of lading is between those that are negotiable and those that are non-negotiable.

(a) With a **negotiable bill of lading**, the person who legally owns the bill of lading owns the goods and has the right to re-route them. A negotiable bill is issued to the seller's order, rather than to a named recipient of the goods. The carrier holds the goods until it receives an original bill of lading endorsed by the seller, which has been presented by the seller to the bank for payment.

(b) With a **non-negotiable bill of lading** (which includes all airway bills), the bill of lading names a recipient to whom the carrier must deliver the goods.

2 Means of payment

FAST FORWARD

> **Payment** may be undertaken by various methods: international bank transfer, international bills of exchange or letters of credit.

In a normal sale of goods, payment is effected in cash, by cheque or by automatic clearing between one bank and another. These methods operate perfectly effectively when the parties and their banks are in one country. International sales of goods are more complicated, and necessitate payment using: international bank transfers, international bills of exchange, or letters of credit.

3 International bank transfers

A common and straightforward method of making an international payment is to carry out (an international) **bank transfer**.

Essentially, this is where the buyer orders **his bank (in Country A) to transfer money to a receiving bank (in Country B)** where it will be credited to the seller. The transfer is carried out electronically. The transaction just described, buyer to seller, is an international credit transfer. These are the most common types of bank transfer, and UNCITRAL has set out a **Model Law on international credit transfers**, which we shall look at shortly.

3.1 Advantages of bank transfers

Bank transfers are **straightforward** to arrange and carry out. They are contained within the systems of the bank as they are carried out **electronically** and do not require reliance on any other systems, such as the postal system.

3.2 Disadvantages of bank transfers

As bank transfers do not have to be arranged in person, there is scope for **fraudulent payments** being made if a person comes into possession of the authentication procedures for the transfers. As bank transfers are quicker than bills of exchange (see later), there is not the same **cancellation period**, should the parties become aware of such fraudulent activity.

4 UN Model Law on International Credit Transfers

FAST FORWARD

The **UN Model Law on International Credit Transfers** sets out the terms on which funds are transferred from a buyer to a seller via the international banking system, and the rights and liabilities that ensue.

The UNCITRAL **Model Law on International Credit Transfers** was prepared in response to a major change in the means by which funds transfers are made internationally. This change involved the increased use of payment orders sent by electronic means rather than on paper.

The Model Law applies to credit transfers where any **sending bank** and its **receiving bank** are in different states: Article 1. The term 'bank' here refers to banks plus other entities who execute payment orders in the manner of a bank.

For the purpose of the Model Law, **branches** of a bank in different states are **separate banks**.

Key terms

Originator: issuer of the first payment order: Article 2.

Sender: the person who issues a payment order, including the originator and the sending bank: Article 2.

'Credit transfer' means the series of operations beginning with the originator's payment order, made for the purpose of placing funds at the disposal of a beneficiary. The term includes any payment order issued by the originator's bank or any intermediary bank intended to carry out the originator's payment order: Article 2.

'Payment order' means an **unconditional instruction**, in any form, by a sender to a receiving bank to place at the disposal of a beneficiary a fixed or determinable amount of money if:

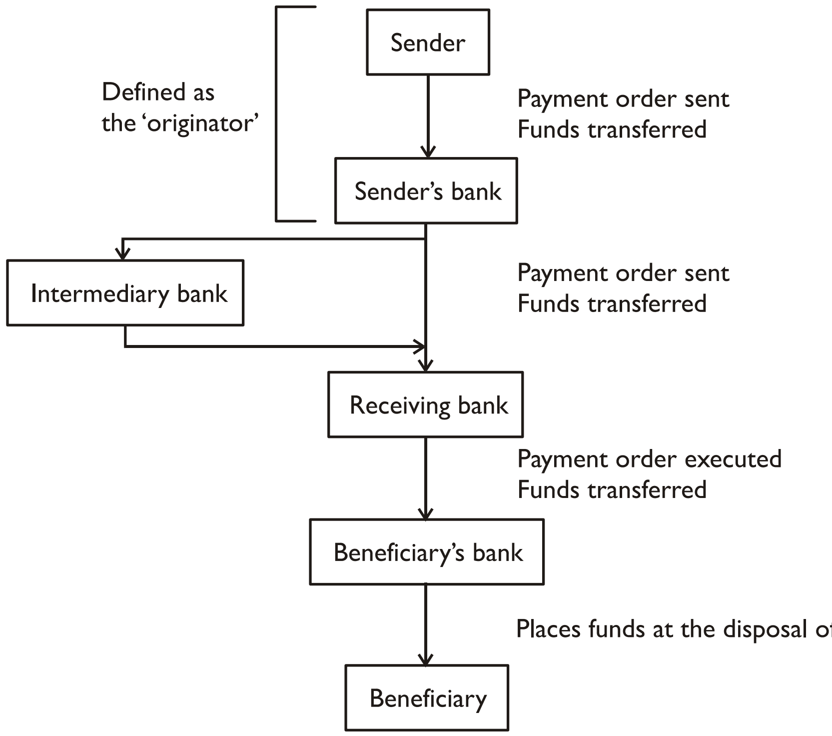
(a) The receiving bank is to be reimbursed by debiting an account of (or otherwise receiving payment from) the sender, and

(b) The instruction does not provide that payment is to be made at the request of the beneficiary: Article 2.

A **payment order** can simply direct the beneficiary's bank to hold the funds: Article 2.

If an instruction to pay is made subject to a condition but the bank executes it by issuing an **unconditional payment order**, it thereafter becomes a full credit transfer: Article 3.

An international credit transfer is thus the **execution of an unconditional instruction** by a person to a bank to make payment to a beneficiary in another country. Clearly the person giving the instruction must make funds available to be passed down the line.



At its simplest an international credit transfer would involve the Sender in Country A instructing his Bank X (the sending bank) to send a payment order and fund directly to Bank Y in Country B (the receiving and the beneficiary's bank) where the Beneficiary has an account. Often however the receiving and the beneficiary's bank are not the same, and indeed there may be intermediary banks along the way.

4.1 Categories of transaction covered by the Model Law

The Model Law applies to **international credit transfers**, not debit transfers. It is not restricted to credit transfers made by electronic means, nor to credit transfers only by businesses. Many credit transfers, both domestic and international, begin with a paper-based payment order from the originator to its bank to be followed by an inter-bank payment order in electronic form.

Many credit transfers require the services of not only the originator's bank and the beneficiary's bank but also one or more intermediary banks. In such a case the credit transfer is initiated by a **payment order** issued by the originator to the originator's bank, followed by payment orders from the originator's bank to the intermediary bank and from the intermediary bank to the beneficiary's bank. The credit transfer also requires payment by each of the three senders to its receiving bank.

Therefore the definition of a credit transfer includes the **entire**

> '**series of operations**, beginning with the originator's payment order, made for the purpose of placing funds at the disposal of a beneficiary, not just to the payment order that passed from a bank in one country to a bank in another country'.

4.2 Scope of the Model Law

Article 4 provides that 'Except as otherwise provided in this law, the rights and obligations of parties to a credit transfer may be varied by their agreement.' This means that, in principle, the Model Law is **not** mandatory law. The parties to a credit transfer may vary their rights and obligations by agreement, with some exceptions which we shall see.

4.3 Obligations of the sender of a payment order

The sender of a payment order may be the originator of the credit transfer, since the originator sends a payment order to the originator's bank. It may also be a bank, since every bank in the credit transfer chain, except the beneficiary's bank, must send its own payment order to the next bank in the credit transfer chain.

Article 5(6) sets out the one real obligation of a sender, 'to pay the receiving bank for the payment order when the receiving bank accepts it'. There is a **special rule** for payment orders that contain a future execution date. In that case the obligation to pay arises when the receiving bank accepts the payment order, 'but payment is not due until the beginning of the execution period'.

4.3.1 Liability for payment of unauthorised payment orders

In an electronic payment order, an **unauthorised person** may have acted as 'sender' and sent the message, but the authentication by code, encryption or the like would be accurate. The Model Law answers the question in three steps.

The **first step** is described in Article 5(1): 'A sender is bound by a payment order … if it was issued by the sender or by another person who had the authority to bind the sender'. The question as to whether the other person had the authority to bind the sender is left to the appropriate legal rules outside the Model Law.

The **second step** described in Article 5(2) is the **most important**, as it is an obligation that the receiving bank cannot avoid by agreement to the contrary.

'When a payment order … is subject to authentication [by agreement between the sender and the receiving bank], a purported sender … is … bound if

(a) The authentication is in the circumstances a commercially reasonable method of security against unauthorised payment offers, and

(b) The receiving bank complied with the authentication.'

In the case of an electronic payment order, it is assumed that the receiving bank determines the **authentication procedures** it is prepared to implement. Therefore, the bank bears all the risk of an unauthorised payment order when the authentication procedures are not at a minimum 'commercially reasonable'.

The determination of what is commercially reasonable will vary from time to time and from place to place depending on the technology available including the cost of implementing the technology in comparison with the risk and such other factors as may be applicable at the time. If the authentication procedure is 'a mere comparison of signature', Article 5(2) does not apply.

If the authentication procedure was **commercially reasonable** and the bank followed the procedure, the purported sender is bound by the payment order. This is justified as follows.

(a) The bank has no means to distinguish the authorised use of the authentication from the unauthorised person use of the authentication. Banks would be unable to offer electronic credit transfers at an acceptable price if they bore the risk that payment orders that were properly authenticated were nevertheless unauthorised.

(b) If the authentication procedure is commercially reasonable and the bank can show that it followed the procedure, the chances are that it was the sender's fault that some unauthorised person learned how to authenticate the payment order.

Finally, the sender or the receiving bank, as the case may be, is responsible for any unauthorised payment order that could be shown to have been sent as a result of the fault of that party.

BPP LEARNING MEDIA

4.4 How does the sender make payment to the receiving bank?

An **originator** may not have an account with the originator's bank and may therefore pay the amount of the credit transfer plus the applicable fees to the originator's bank in cash. This is often the case when an individual originates the payment order. In most cases however the originator will have an account with the sending bank, which will have an account for the originator at the receiving bank.

In any such case, payment to the receiving bank will normally be made by a debit to the account of the sender held by the **receiving bank**. The receiving bank is in a position to **determine** whether there is a **sufficient credit balance** in the account, or whether it is **willing to extend credit** to the sender to the extent of the resulting debit balance. Therefore, Article 6(a) provides that payment is made when the debit is made.

The reverse situation may also occur. The receiving bank maintains an account with the sending bank. Alternatively, both the sending bank and the receiving bank may maintain accounts with a third bank. Then the **sending bank** can **pay** the **receiving bank** by **crediting** the **receiving bank's account** or by instructing the third bank to credit the receiving bank's account, as the case may be. The result in either of those two situations is that the credit balance of the receiving bank with the sending bank or with the third bank is increased, with a concurrently larger credit risk.

Normally that would be acceptable to the receiving bank. However, on occasion the **credit balance**, and the resulting **credit risk**, may be more than the receiving bank was willing to have with the sending bank or the third bank. Therefore, the Model Law provides in Article 6(b)(i) and (ii) that payment takes place when the credit

> 'is used [by the receiving bank] or, if not used, on the banking day following the day on which the credit is available for use and the receiving bank learns of that fact'.

In other words, if the **receiving bank** does not use the credit and **does not wish to bear the credit risk**, it has a **short period** of time to **notify** the sending bank that the payment is not acceptable to it.

The receiving bank may also seek to net the obligation of the sending bank with other obligations arising out of other payment orders. The netting may be based on a **bilateral 'netting agreement'** between the two banks, or on the rules of a funds transfer system that provides for the settlement of obligations among participants either bilaterally or multilaterally.

If netting takes place under any of these circumstances, Article 6(b)(iv) provides that payment to the various receiving banks for each of the individual payment orders occurs when **final settlement** is made in favour of the receiving bank in accordance with the agreement or the rules. The Model Law does not take a position as to whether a netting agreement is valid or effective under the applicable law.

4.5 Obligations of the receiving bank

The obligations of a **receiving bank** are divided into the **obligations** that are part of a **successful credit transfer** and the **obligations** that **arise** when **something goes wrong**. Most payment orders that are received by a bank are executed promptly and the credit transfer is completed successfully. In a real sense, a receiving bank in such a credit transfer never has an unexecuted obligation in regard to the payment order.

4.5.1 Obligations to execute a payment order

Articles 8(2) and 10(1) set out the obligations of a **receiving bank** to execute a payment order that it 'accepts'. The **obligation** of a receiving bank other than the beneficiary's bank is to **issue a payment order** that will **properly implement the payment order** received. The **obligation** of the **beneficiary's bank** is to **place the funds** at the **disposal** of the **beneficiary**. Until the receiving bank 'accepts' the payment order, it has no obligation to execute it.

In most cases a **receiving bank** (that is not the beneficiary's bank) **accepts** a **payment order** at the point when it **issues it own payment order** intended to carry out the payment order received. A **beneficiary's bank accepts** a payment order at the point **when it credits the account of the beneficiary**. In those two situations the receiving bank and the beneficiary's bank undertake their primary obligation and discharge that obligation by the same act.

However, a receiving bank may **accept** a payment order in some other way before it executes the payment order received.

(a) Some funds **transfer systems** have a rule that a receiving bank is required to execute all payment orders it receives from another member of the funds transfer system. In such a case the receiving bank accepts the payment order when it receives it.

(b) A receiving bank **may debit the account** of the **sender** as the means of **receiving payment** or may notify the sender that it accepts the payment order. It therefore accepts the payment order when it debits the account or gives the notice.

(c) The philosophy of the Model Law is that a bank that receives a payment order and payment for it must either **implement the payment** order or **give notice of rejection**. If the receiving bank neither implements the payment order nor rejects it within the required time, the receiving bank is deemed to have accepted the payment order and the associated obligations. Article 11 provides that normally the receiving bank must execute the payment order by the banking day after it is received and for value as of the day of receipt.

4.5.2 Obligations of the receiving bank when something goes wrong

The receiving bank also has **obligations** when something goes wrong.

Some payment orders may be **defective**. A message received may contain insufficient data to be a payment order or a payment order may not be executed because of insufficient date.

For example, a payment order that expresses the amount of money to be transferred in two different ways, such as in words and in figures, may indicate the amount in an inconsistent manner. The same thing may occur in identifying the beneficiary, for example, by name and by account number. Where there is **insufficient data**, or an **inconsistency in the data** which the receiving bank detects, the receiving bank is obligated to notify the sender.

The receiving bank may have issued a conforming payment order but completion may be delayed and neither the originator nor the beneficiary knows what has happened. Article 13 provides that each receiving bank is requested to **assist the originator** and to seek the assistance of the next receiving bank to complete the banking procedures of the credit transfer.

If the credit transfer is not completed, Article 14(1) provides that

> 'the originator's bank is obligated to refund to the originator any payment received from it, with interest from the day of payment to the day of refund'.

The originator's bank can in turn recover what it paid to its receiving bank, with interest, and that bank can recover from its receiving bank. The **chain of responsibility** for refunding stops at the bank that is unable to complete the credit transfer.

4.6 Liability of any bank for delaying payment

The liability of a bank in the chain for causing delay is to pay interest: Article 17. It is current practice in many credit transfer arrangements for a bank that delays implementing a payment order receiving to issue its payment order for the amount of the transfer plus the appropriate amount of interest for the delay. If the bank does so, its receiving bank is obligated to pass on that interest to the beneficiary. Since the delaying bank has acted in a manner calculated to **compensate the beneficiary**, the delaying bank is discharged of its liability. If the interest is not passed on to the beneficiary as contemplated by Article 17, the beneficiary has a direct right to recover the interest from the bank that holds it.

The remedy of **recovery of interest** is the **only remedy available** to the originator or the beneficiary, except when the failure to execute the payment order, or to execute it properly occurred

> '(a) with the specific intent to cause loss, or (b) recklessly and with actual knowledge that loss would be likely to result'.

In those unusual circumstances, recovery may be based on whatever doctrines may be available in the legal system outside the Model Law: Article 18.

4.7 Completion of credit transfer and its consequences

A credit transfer is completed when the beneficiary's bank accepts a payment order for the benefit of the beneficiary: Article 19. At that point the banking system has completed its obligations to the originator. The beneficiary's bank's subsequent failure to act properly, if that should occur, is the beneficiary's concern. It is not covered by the Model Law but is left to the law otherwise regulating the account relationship.

In many credit transfers the originator and the beneficiary are the same person. The bank customer is merely shifting its funds from one bank to another. In such a case completion of the credit transfer obviously does not change the legal relationship between the customer as originator and the originator's bank and between the customer as beneficiary and the beneficiary's bank.

5 Bills of exchange

FAST FORWARD

The parties to a bill of exchange are the **drawer**, the **drawee** (the bank) and the **payee** initially. The drawee may become its acceptor by accepting the bill. The payee may become an endorser by endorsing the bill to another holder, or the bearer.

Key terms

According to Article 3 of the UN Convention (see Section 6 below) an international **bill of exchange** is a written instrument which:

(a) Contains an unconditional order whereby the drawer directs the drawee to pay a **definite sum** of money to the **payee** or to his order;

(b) Is **payable on demand** or at a **definite time**

(c) Is dated

(d) Is signed by the drawer

The fact that is it an international bill of exchange must be clearly stated: Article 1. It should therefore contain the words 'International bill of exchange (UNCITRAL Convention)'.

The **drawee** is a person (usually a bank) on whom a bill is drawn and who has not accepted it.

The **drawer** is the person (or persons) making the payment (the buyer).

The **payee** is the person (or persons) in whose favour the drawer has directed payment (the seller).

Often the bill is presented to the drawee before it is actually payable, so that the drawee can 'accept' the bill in writing (normally just by a signature). On an accepted bill of exchange the principal debtor liable to pay is the drawee (the bank) rather than the drawer. Practically speaking, a bill of exchange which has been accepted means that the drawer has irrecoverably made funds available for payment to the bank.

A bill of exchange may be transferred from the payee to another 'holder' by endorsement by signing it. This signature may be 'in blank' (just a signature), which means that the bill is then payable to bearer, ie any person who presents it for payment. Alternatively, the endorsement may be 'special', eg 'pay X, signed Y (the payee)'. In this case, X becomes the holder of the bill and may present it for payment.

A **cheque** is a common example of a bill of exchange, defined as a bill of exchange drawn on a banker and payable on demand but **international bills of exchange** must be used in international situations.

6 UN Convention on International Bills of Exchange and International Promissory Notes

FAST FORWARD

The UN Convention on International Bills of Exchange and International Promissory Notes sets out the terms on which buyers may pay sellers by means of a written instrument. A bill of exchange represents a right to receive payment, and this right can be transferred.

Key term

An **international bill of exchange** according to Article 2 of the Convention is a bill of exchange (as defined in Article 3 above – *not* a cheque) which specifies at least two of the following places and indicates that any two so specified are situated in different states:

(a) The place where the bill is drawn
(b) The place indicated next to the signature of the drawer
(c) The place indicated next to the name of the drawee
(d) The place indicated next to the name of the payee
(e) The place of payment

6.1 Example: International bill of exchange

International Bill of Exchange (UNCITRAL Convention)

On behalf of Buyer Inc of Country A, I order Barchester Bank plc of London, UK$_{(c)}$ to pay the sum of $30,000 to Seller SA of Country B$_{(d)}$ at the Smalltown branch of Country B$_{(e)}$.

Signed Peter Barket Julie Sharman …………………………………. on behalf of Buyer Inc, Country A

Date 19 August 2003 …………………………………….

At Largetown, Country A ……………………………………… (a)(b)

In this example, the letters (a) to (e) indicate the requirements set out in the key term above. As the bill of exchange designates three different states (Country A, UK and Country B), and it states that it is, this is an international bill of exchange.

A bill that states it is an international bill of exchange (UNCITRAL Convention) and which bears the signature of the drawer or the acceptance of the drawee, but which lacks other elements, may still be completed. It will then be effective as a bill: Article 12(1).

If such a bill is completed without authority then a party who signed the instrument before the completion may invoke such lack of authority as a defence against a person who had knowledge of such a lack of authority when he became a holder. But a party who signed the instrument after the completion is liable according to the terms of the instrument so completed: Article 12(2).

We shall look now in detail at some of the terms used in the UN Convention, and at the rights and liabilities the Convention sets out.

Exam focus point

International bills of exchange are highly examinable but are also easy to overlook. Ensure that you are able to write enough on them to cover a 10-mark knowledge question.

6.2 How much the bill is for

The sum payable on a bill is deemed to be a **definite sum**. This is even if the bill states that it is to be paid:

- With interest
- By instalments
- According to a rate of exchange indicated in the bill
- To be determined as directed by the bill
- In a currency other than the currency in which the sum is expressed in the bill: Article 7

If there is a discrepancy between the sum expressed in words and the sum expressed in figures, the sum payable by the instrument is the sum expressed in words: Article 8(1).

If a bill states that the sum is to be paid with interest, without specifying the date from which interest is to run, interest runs from the date of the bill: Article 8(4). The rate at which interest is to be paid may be expressed either as a definite rate or as a variable rate.

6.3 When the amount is payable

A bill is **payable on demand** if it states that it is payable at sight or on demand or on presentation, or if no time of payment is expressed: Article 9(1). The time of payment of a bill payable on demand is the date on which the instrument is presented for payment: Article 9.

A bill which is payable at a **definite time** and which is accepted or endorsed or guaranteed after maturity is a bill payable on demand as regards the acceptor, the endorser or the guarantor.

A bill is deemed to be payable at a **definite time** if it states that it is payable (Article 9(3)):

(a) On a stated date or at a fixed period after a stated date or at a fixed period after the date of the instrument;

(b) At a fixed period after sight (determined by the date of acceptance or, if the bill is dishonoured by non-acceptance, by the date of protest or, if protest is dispensed with, by the date of dishonour);

(c) By instalments.

6.4 Parties to the bill

6.4.1 The payee

The payee is the person or persons to whom the bill's drawer has instructed payment to be made (Seller SA in the example above).

A bill may be drawn payable to two or more payees (Article 10(1)). In this case it is payable to any one of them.

6.4.2 The drawer

The drawer is the person who has instructed payment to be made, that is Buyer Inc in the example above. The drawer is initially principally bank on the bill, since a person is liable on a bill once he or his agent signs it: Article 33. However, a **forged signature** does not impose any liability on the person whose signature was forged, unless he consents to be bound by the forged signature or represents that it is his own.

The drawer agrees that if a bill is dishonoured by non-acceptance or by non-payment and it is protested as necessary, he will pay the bill to the holder, or to any endorser or any endorser's guarantor who takes up and pays the bill: Article 38(1).

The drawer may exclude or limit his own liability for acceptance or for payment by an express stipulation in the bill, if another party is or becomes liable on the bill: Article 38(2).

6.4.3 The drawee and the acceptor

The **drawee** is the person – nearly always a bank – who is instructed by the drawer to pay the payee: Barchester Bank plc in the example above.

The drawee (or another person) may, before the bill is due for payment, 'accept' liability to pay it. The **acceptor** becomes principally liable on the bill, above the drawer.

The drawee is not liable on a bill until he accepts it: Article 40(1). The acceptor engages that he will pay the bill in accordance with the terms of his acceptance to the holder, or to any party who takes up and pays the bill: Article 40(2).

An **acceptance** must be written on the front or back of the bill and may be effected (Article 41):

(a) By the signature of the drawee accompanied by the word 'accepted' or similar import; or
(b) By the signature alone of the drawee.

A bill may be accepted before, at or after maturity, or after it has been dishonoured by non-acceptance or by non-payment: Article 42(2).

An acceptance must be **unqualified**. An acceptance is qualified if it is conditional or varies the terms of the bill, for instance if it accepts only part of the sum payable: Article 43(1). If the drawee stipulates in the bill that his acceptance is subject to qualification:

(a) He is nevertheless bound according to the terms of his qualified acceptance;
(b) The bill is dishonoured by non-acceptance.

Any bill may be **presented for acceptance**, and it must be presented for acceptance:

(a) If the drawer has stipulated so in the bill; or
(b) If the bill is payable at a fixed period after sight; or
(c) If the bill is payable elsewhere than at the residence or place of business of the drawee, unless it is payable on demand: Article 49.

A bill is duly presented for acceptance if it is **presented in accordance with the following rules** (Article 51):

(a) The holder must present the bill to the drawee on a business day at a reasonable hour;
(b) Presentation for acceptance may be made to a person or authority other than the drawee if that person or authority is entitled under the applicable law to accept the bill;
(c) If a bill is payable on a fixed date, presentation for acceptance must be made before or on that date;
(d) A bill payable on demand or at a fixed period after sight must be presented for acceptance within one year of its date;
(e) A bill in which the drawer has stated date or time-limit for presentation for acceptance must be presented on the stated date or within the stated time-limit.

If a bill which must be presented for acceptance is not so presented, the drawer, the endorsers and their guarantors are **not liable** on the bill. However, failure to present a bill for acceptance does not discharge the guarantor of the drawee of liability on the bill: Article 53.

A bill is considered to be **dishonoured by non-acceptance** under Article 54 if the drawee, upon due presentation, expressly refuses to accept the bill. This will also be the case if acceptance cannot be obtained with reasonable diligence or if the holder cannot obtain the acceptance to which he is entitled under this Convention.

The holder may then exercise an immediate right of recourse against the drawer, the endorsers and their guarantors. The holder may then claim payment from the guarantor of the drawee upon any necessary protest.

If a bill payable on demand is presented for acceptance, but acceptance is refused, it is not considered to be dishonoured by non-acceptance: Article 54(3).

6.4.4 The guarantor

Payment of a bill, whether or not it has been accepted, **may be guaranteed**, as to the whole or part of its amount, for the account of a party or the drawee. A guarantee may be given by any person, who may or may not already be a party: Article 46. A guarantee must be written on the instrument or on a slip affixed therefore *('allonge')*, and it may be effected by a signature alone on the front of the bill. A signature alone on the front of the bill, other than that of the drawer or the drawee, is a guarantee.

A guarantor may specify the person for whom he has become guarantor. In the absence of such specification, the person for whom he has become guarantor is the acceptor or the drawee.

The **liability** of a guarantor on the bill is of the same nature as that of the party for whom he has become guarantor: Article 47.

The guarantor who pays the bill may recover from the party for whom he has become guarantor, and from the parties who are liable on it to that party, the amount paid and any interest: Article 48(2).

6.5 Transferring an international bill of exchange

Instead of presenting the bill to the acceptor for payment, the payee may instead choose to **transfer** the right to receive payment to another person. For instance, Seller SA in the example above may owe $30,000 to his own supplier, Supplier Ltd. Instead of receiving payment for the bill of exchange and drawing a new one to pay Supplier Ltd, Seller SA may choose instead to use Buyer Inc's bill to pay Supplier Ltd.

Transfer is effected by the process of endorsement: Seller SA becomes the **endorser**, and Supplier Ltd the **endorsee**.

A bill is **transferred** by endorsement and delivery of the bill by the endorser to the endorsee, or by mere delivery of the instrument if the last endorsement is in blank: Article 13.

An instrument may be transferred in this way after maturity, except by the drawee, or the acceptor: Article 24.

6.5.1 Endorsement

An **endorsement** must be written on the instrument or on a slip affixed thereto *('allonge')*. It must be signed: Article 14(1). An endorsement may be:

(a) **In blank**, that is, by a signature alone or by a signature accompanied by a statement to the effect that the bill is payable to a person in possession of it;

(b) **Special**, that is, by a signature accompanied by an indication of the person to whom the bill is payable.

A signature alone, other than that of the drawee, is an endorsement only if placed on the back of the bill.

If the drawer has inserted in the instrument, such words as 'not negotiable', 'not transferable', 'not to order', 'pay (x) only', or similar, the bill may not be transferred except for purposes of collection. Any endorsement, even if it does not contain words authorising the endorsee to collect the instrument, is deemed to be an endorsement for collection: Article 17(1).

An endorsement must be unconditional: Article 18. A conditional endorsement transfers the bill whether or not the condition is fulfilled. The condition is ineffective as to those parties and transferees who are subsequent to the endorsee.

An endorsement in respect of a part of the sum due under the instrument is ineffective as an endorsement: Article 19.

If there are two or more endorsements, it is presumed, unless the contrary is proved, that each endorsement was made in the order in which it appears on the instrument: Article 20.

If an endorsement contains the words 'for collection', 'for deposit', 'value in collection', 'by procuration', 'pay any bank', or words of similar import authorising the endorsee to collect the instrument, the endorsee is a holder who (Article 21(1)):

(a) May exercise all rights arising out of the instrument;
(b) May endorse the instrument only for purposes of collection;
(c) Is subject only to the claims and defences which may be set up against the endorser.

The endorser for collection is **not liable** on the bill to any subsequent holder.

If an endorser contains the words 'value in security', 'value in pledge', or any other words indicating a pledge, then according to Article 22, the endorsee is a holder who:

(a) May exercise all rights arising out of the bill;
(b) May endorse the bill only for purposes of collection;

If such an endorsee endorses for collection, he is **not liable** on the instrument to any subsequent holder.

If an endorsement is forged, the person whose endorsement is forged, or a party who signed the bill before the forgery, has the right to recover compensation for any damage that he may have suffered because of the forgery against:

(a) The forger;

(b) The person to whom the instrument was directly transferred by the forger;

(c) A party or the drawee who paid the instrument to the forger directly or through one or more endorsees for collection: Article 25(1).

An **endorsee** for collection is not liable however if he is **without knowledge** of the forgery at the time he pays the principal, or advises him of the receipt of payment, or at the time he receives payment, if this is later. This is unless his lack of knowledge is due to his **failure to act in good faith** or to exercise reasonable care: Article 25(2).

The **drawee** who pays a bill is also not liable if, at the time he pays the instrument, he is **without knowledge** of the forgery, unless his lack of knowledge is due to his **failure to act in good faith** or to exercise reasonable care.

6.5.2 Liability of the endorser

Endorsers agree that upon dishonour of the bill by non-acceptance or by non-payment, and upon any necessary protest, they will pay the bill to the holder, or to any subsequent endorser or any endorser's guarantor who takes up and pays the bill: Article 44(1). An endorser may exclude or limit his own liability by an express stipulation on the bill. Such a stipulation is effective only with respect to that endorser.

Unless otherwise agreed, a person who transfers a bill by endorsement and delivery, or by mere delivery, represents to the holder to whom he transfers the bill (the transferee) that:

(a) It does not bear any forged or unauthorised signature;

(b) It has not been materially altered;

(c) At the time of transfer, he has no knowledge of any fact which would impair the right of the transferee to payment of the bill against the acceptor or, in the case of an unaccepted bill, the drawer: Article 45(1).

The transferor is liable only if the transferee took the instrument without knowledge of the matter giving rise to such liability.

If the transferor is liable the transferee may recover, even before maturity, the amount paid by him to the transferor, with interest.

6.5.3 The holder of a bill

Because a bill is transferred *either* by endorsement *or* simply by transfer, the person to whom it is transferred is known as the **holder** of the bill.

A person is a **holder** if s/he is:

(a) The payee in possession of the bill, or

(b) In possession of a bill which has been endorsed to him, or on which the last endorsement is in blank, and on which there appears an uninterrupted series of endorsements. This is even if any endorsement was forged or was signed by an agent without authority: Article 15(1).

If an endorsement in blank is followed by another endorsement, the person who signed this last endorsement is deemed to be an endorsee by the endorsement in blank.

A person may still be a holder even if the bill was obtained by him or any previous holder under circumstances, including incapacity or fraud, duress or mistake of any kind, that would give rise to a claim to, or a defence against liability on, the bill.

The holder of a bill on which the last endorsement is in blank may:

(a) Further endorse it either by an endorsement in blank or by a special endorsement;

(b) Convert the blank endorsement into a special endorsement by indicating in the endorsement that the bill is payable to himself or to some other specified person; or

(c) Transfer the bill merely by delivery: Article 16.

The holder of an instrument has all the rights conferred on him by this Convention against the parties to the instrument, and may transfer them as above: Article 27.

The transfer of an instrument by a protected holder vests in any subsequent holder the rights to and on the instrument which the protected holder had: Article 31.

6.6 Presenting the bill for payment

To obtain payment of the bill, it must be duly '**presented for payment**'. This means that the holder must present the bill to the drawee or the acceptor on a business day at a reasonable hour: Article 55.

A bill which is **not payable on demand** must be presented for payment **on the date of maturity** or on **one of the two** business days which follow. A bill which is **payable on demand** must be presented for payment within **one year** of its date.

A bill must be presented for payment:

(a) At the place of payment specified in it;

(b) If no place of payment is specified, at the address of the drawer or the acceptor indicated in it; or

(c) If no place of payment is specified and the address of the drawee or the acceptor is not indicated, at the principal place of business or habitual residence of the drawee or the acceptor.

An instrument which is presented at a clearing-house is duly presented for payment if the law of the place where the clearing-house is located or the rules or customs of that clearing-house so provide.

The requirement to present for payment may be dispensed with in some cases, most notably where it has been protested for dishonour by non-acceptance (see below): Article 56(3). In all other cases, if an instrument is not duly presented for payment, the drawer, the endorsers and their guarantors are not liable on it: Article 57(1). Failure to present an instrument for payment does not however discharge the acceptor, and their guarantors, or the guarantor of the drawee, of liability on it.

6.6.1 Dishonour for non-payment

A bill is dishonoured by non-payment under Article 58:

(a) If payment is refused upon due presentation or if the holder cannot obtain the payment to which he is entitled;

(b) If presentation for payment is dispensed with and the instrument is unpaid at maturity.

If a bill is dishonoured by non-payment, the holder may, subject to the rules on protests, exercise a right of recourse against the endorsers and their guarantors.

6.7 Protesting the bill for dishonour

If an instrument is dishonoured by non-acceptance or by non-payment, the holder may exercise a right of recourse only after the instrument has been duly **protested for dishonour**: Article 59. A protest is a statement of dishonour drawn up at the place where the bill has been dishonoured and signed and dated by a person authorised in that respect by the law of that place. The statement of dishonour must specify:

(a) The person at whose request the bill is protested;

(b) The place of protest;

(c) The demand made and the answer given, if any, or the fact that the drawee or the acceptor could not be found: Article 60. A protest may be made on the instrument or *'allonge'*, or as a separate document.

Protest for dishonour must be made on the day on which the bill is dishonoured or on one of the four business days which follow: Article 61.

If a bill which must be protested for non-acceptance or for non-payment is not duly protested, the drawer, the endorsers and their guarantors are not liable on it (Article 63), but it does not discharge the acceptor or the guarantor of the drawee of liability on it.

The holder, upon dishonour of a bill by non-acceptance or by non-payment, must give notice of such dishonour:

(a) To the drawer and the last endorser;

(b) To all other endorsers and guarantors whose addresses the holder can ascertain on the basis of information contained in the bill: Article 64.

Notice of dishonour operates for the benefit of any party who has a right of recourse on the instrument against the party notified.

If a person who is required to give notice of dishonour fails to give it to a party who is entitled to receive it, he is liable for any damages which that party may suffer from such failure: Article 68.

6.8 How much is payable by the liable party?

The holder may exercise his rights on the bill against any one party, or several, or all parties, liable on it and is not obliged to observe the order in which the parties have become bound. Any party who takes up and pays the bill may exercise his rights in the same manner against parties liable to him: Article 69(1).

At maturity the amount payable to the holder is the amount of the instrument with interest, if interest has been stipulated: Article 70.

After maturity, the amount payable to the holder is the amount of the bill with interest, if interest has been stipulated for, to the date of maturity at the rate stipulated plus any expenses of protest and of the notices given by him. The amount payable on a bill paid **before maturity** is often subject to a discount from the date of payment to the date of maturity.

A court may award damages or compensation for additional loss caused to the holder by reason of delay in payment.

Under Article 71 a party who pays a bill and is thereby discharged in whole or in part of his liability on it may recover from the parties liable to him:

(a) The entire sum which he has paid;
(b) Interest on that sum from the date on which he made payment;
(c) Any expenses of the notices given by him.

An instrument must be paid in the currency in which the sum payable is expressed: Article 75.

A party is discharged of liability on the bill when he pays the holder, or a party subsequent to himself who has paid the bill and is in possession of it, the amount due:

(a) At or after maturity; or
(b) Before maturity, upon dishonour by non-acceptance: Article 72(1).

6.9 Advantages of international bills of exchange

(a) They provide a **convenient method** of **collecting payments** from buyers in a different state.

(b) The seller can seek **immediate finance**, using term bills of exchange, instead of having to wait until the period of credit expires (ie until the maturity of the bill). At the same time, the buyer is allowed the full period of credit before payment is made.

(c) On payment, the foreign buyer keeps the bill as **evidence of payment**, so that a bill of exchange also serves as a receipt.

(d) If a bill of exchange is dishonoured, it may be used by the drawer to **pursue payment** by means of legal action in the drawee's country.

(e) The buyer's bank might add its name to a bill to indicate that it **guarantees** payment at maturity.

7 Letters of credit

FAST FORWARD

A basic **letter of credit** is issued by the issuing bank at the request of the buyer, and advised to the seller's advising bank. Provided the requisite documents are presented by the seller, payment is made by the advising bank and reimbursed by the issuing bank.

Letters of credit are **irrevocable** unless otherwise stated; they may take a variety of forms.

Letters of credit provide a method of payment in international trade which gives the seller a risk-free method of obtaining payment, and which ensures for the buyer that the seller complies to the letter with the terms of the underlying sales contract.

(a) The **seller receives immediate payment** of the amount due to him, less any discount, instead of having to wait until the end of the credit period for payment. To obtain payment, the seller must present documents which comply strictly with the terms of the letter of credit.

(b) The buyer is able to get a **period of credit** before having to pay for the imports.

The second procedure is are as follows.

(a) The buyer and the seller first of all agree a **contract for the sale of the goods**, which provides for payment through a letter of credit.

(b) The **buyer** (the **applicant**) then requests a bank in his country to issue a **letter of credit** in favour of the seller. This bank which issues the letter of credit is known as the **issuing bank.**

(c) The issuing bank, by issuing its letter of credit, **guarantees payment** to the **seller** (the beneficiary/payee), provided the seller complies with the requirements as to documentation. Banks are involved in the credits, not in the underlying contracts.

(d) The issuing bank asks the seller's bank in the seller's country to **advise the credit** to the seller.

(e) The **advising bank** establishes the authenticity of and agrees to **handle the credit** (on terms arranged with the issuing bank).

(f) The advising bank (in the seller's country) might be required by the issuing bank to add its own **'confirmation'** to the credit. The advising bank would then be adding its own guarantee of payment to the guarantee already provided by the issuing bank.

(g) A **letter of credit arrangement** must be made between the seller, the buyer and participating banks **before the sale takes place**.

Once the advising bank informs the seller of the letter of credit, and/or confirms it, the seller may ship the goods. The documents called for in the letter of credit, such as the invoice or bill of lading, are presented by the seller to the advising bank. If they comply with the letter of credit, the seller is paid and the advising bank forwards the documents to the issuing bank. Once the latter has checked the documents, it pays the advising bank. It then releases the documents to the buyer so the latter can claim the goods from the carrier.

Letters of credit are **slow to arrange**, and **administratively cumbersome**. However, they are usually essential where the **risk of non-payment is high**, or when **dealing for the first time with an unknown buyer**.

There are various types of letter of credit.

(a) **Confirmed letter of credit**: the advising bank (for a fee) confirms that payment will be made to the seller provided the requisite documents are presented by the seller, payment being made by the advising bank even if the issuing bank or buyer fails to reimburse the payment.

(b) **Unconfirmed letter of credit**: the advising bank does not guarantee payment even in the event of default by the issuing bank, but confirms that the letter of credit is authentic.

(c) **Revocable letter of credit**: can be amended or cancelled by the buyer at any time without notice to the seller. They are rarely used since they give little protection to the seller.

(d) **Irrevocable letter of credit**: it cannot be amended or called without agreement of all parties.

(e) **Standby letters of credit** are used in cases where another, less secure, method of payment has been agreed. If the other method fails then the seller can claim payment under the standby. These are subject to the UN Convention on Independent Guarantees and Standby Letters of Credit.

(f) **Revolving letters of credit** are used where there is a course of dealings between buyer and seller, so it is easier to keep a letter of credit open at all times which may revolve automatically or subject to certain conditions.

(g) The letter of credit may be **time-revolving**, which means it is reinstated after use for the next regular shipment, until the amount of the credit has been used up. If it is **value-revolving**, once its value has been used it can be reinstated in the same amount, for further shipments.

(h) A **transferable letter of credit** allows the seller to transfer the right to receive payment to another person who was not party to the original contract, such as the original supplier of the goods.

(i) Alternatively, a **back to back letter of credit** allows the seller to use the buyer's letter of credit as security to issue a second letter of credit from him as buyer to the original supplier or seller.

8 Letters of comfort

FAST FORWARD

A **letter of comfort** purports to assure a creditor that a third party will ensure payment of its debtor's debts, but it has no legal effect.

A letter of comfort is a letter issued to a **third party lender** by a **parent company**. The letter acknowledges the parent company's approval of a **subsidiary company's** attempt at raising finance. The letter of comfort does not guarantee the loan given to the subsidiary company. It merely gives reassurance to the lender that the parent company is aware and approves of the situation.

The importance of letters of comfort comes to the fore when the subsidiary nears insolvency, or actually becomes insolvent. At such a time lenders, other creditors and indeed the directors of the insolvent subsidiary look to the parent company and its letter of comfort, usually unsuccessfully as the cases decided to date enforce the rule that they are not binding on the parent.

BPP LEARNING MEDIA

Re Augustus Barnett & Son Ltd 1986

The facts: An action for fraudulent trading in an insolvency (see Chapter 17) was brought against a company and against its parent company. The court refused to lift the corporate veil (see Chapter 9) and identify the insolvent subsidiary with its parent company, which had issued and frequently confirmed letters of comfort to the subsidiary's creditors.

Decision: In this case the subsidiary's directors had not been fraudulent, and anyway the parent's directors had not been involved in management, so the action failed. However, it raised the suggestion that the veil of incorporation could be lifted if the parent's conduct indicated an assumption of liability.

Kleinwort Benson Ltd v Malaysia Mining Corporation Berhad 1989

The facts: Kleinworts lent £5m to a Malaysian mining company, and requested a letter of comfort from the borrower's parent company. The parent wrote: '...It is our policy to ensure that the business of (the borrower) is conducted in such a way that (it) is at all times in a position to meet its liabilities to you...', and Kleinworts evidently placed reliance on this when advancing the funds. There was a subsequent liquidity crisis in the tin industry and Kleinworts made a demand on the parent, based on the letter of comfort.

Decision: The Court of Appeal reasoned that the statement as to 'ensuring' the subsidiary's ability to meet its obligations did not constitute a promise to maintain the parent's supportive policy in the future, and there was no express promise to pay. There is some debate over this decision, and certainly the wording in letters of comfort has to be very precisely phrased if the parent is to avoid liability.

Exam focus point

Exam questions often ask for an explanation of the meaning of letters of comfort and credit as in December 2008.

Chapter Roundup

- **Carriage** is an important feature of international contracts for the sale of goods. The **bill of lading** is therefore an important document because it is evidence of when the goods have passed to the carrier. This is a sign that risk has passed to the buyer.
- Bills of lading may be **negotiable** or **non-negotiable**, and they may take the form of an inland, ocean or through bill of lading, or an airway bill.
- **Payment** may be undertaken by various methods: international bank transfer; international bill of exchange; or letters of credit.
- **The UN Model Law on International Credit Transfers** sets out the terms on which funds are transferred from a buyer to a seller via the international banking system, and the rights and liabilities that ensue.
- The parties to a bill of exchange are the **drawer**, the **drawee** (the bank) and the **payee** initially. The drawee may become its acceptor by accepting the bill. The payee may become an endorser by endorsing the bill to another holder, or the bearer.
- **The UN Convention on International Bills of Exchange and International Promissory Notes** sets out the terms on which buyers may pay sellers by means of a written instrument. A bill of exchange represents a right to receive payment, and this right can be transferred.
- A basic **letter of credit** is issued by the issuing bank at the request of the buyer, and advised to the seller's advising bank. Provided the requisite documents are presented by the seller, payment is made by the advising bank and reimbursed by the issuing bank.
- Letters of credit are **irrevocable** unless otherwise stated; they may take a variety of forms.
- A **letter of comfort** purports to assure a creditor that a third party will ensure payment of its debtor's debts, but it has no legal effect.

Quick Quiz

1 What is a bill of lading?

2 When the contract covers transport from one specified place to another, the bill of lading is most likely to be in the form of ....

3 The legal owner of a negotiable bill of lading has the right to re-route them.

True ☐

False ☐

4 What is the objective of the sender of a credit transfer?

5 The principal debtor liable to pay an accepted bill of exchange is the .... of the bill.

6 When a holder of a bill of exchange endorses it in blank, it becomes payable to ....

7 In what particular circumstances might you chose to use letters of credit to receive payment?

(1) .... , or

(2) ....

8 In issuing a letter of credit, the issuing bank unconditionally guarantees payment to the seller.

True ☐

False ☐

9 If the buyer issues a letter of credit to a seller who in turn needs to pay his own supplier, the form of the letter of credit should be either:

(1) ....

(2) ....

Answers to Quick Quiz

1 A bill of lading is a legal document which is given by the actual carrier of the goods to the shipper of the goods.

2 When the contract covers transport from one specified place to another, the bill of lading is most likely to be in the form of **a through bill of lading**.

3 True. A legal owner can re-route.

4 The sender's objective is to pay the receiving bank for the payment order when the receiving bank accepts it.

5 The principal debtor liable to pay an accepted bill of exchange is the **acceptor or drawee** of the bill.

6 When a holder of a bill of exchange endorses it in blank, it becomes payable to **bearer**.

7 (1) If the buyer was new and unknown to you
(2) If there was a large risk of non-payment

8 False. The seller must comply with the requirements as to presentation of documents to receive payment.

9 (1) A transferable letter of credit, or
(2) A back-to-back letter of credit.

Now try the question below from the Exam Question Bank

Number	Level	Marks	Time
Q7	Examination	10	18 mins

P A R T C

International business forms

7

Agency

Topic list	Syllabus reference
1 Role of agency and agency relationships	C1(a)
2 Formation of agency	C1(b)
3 Authority of the agent	C1(c)
4 Relations between agent and third parties	C1(d)
5 International agency	C1(d)

Introduction

In this chapter we examine how an **agency relationship** arises and how the **agent's authority** is acquired and defined. Agency is the foundation of most business relationships where more than one person engages in commerce together. Examples include **partnerships** and **companies**, which we shall introduce in the next two chapters.

'Agents' are employed by **'principals'** to perform tasks which the principals cannot do or do not wish to perform themselves. This is often because the principal does not have the time or expertise to carry out the task.

If business people did not employ the services of agents they would be weighed down by contractual details, and would probably get little else done!

When parties enter into an **agency arrangement**, the principal gives a measure of authority to the agent to carry out tasks on his behalf. We shall look at the extent and limits of that authority in Section 3.

The agent **contracts and deals with third parties** on behalf of the principal. We shall look at the relationship between agents and the third parties they deal with in Section 4.

Lastly, we shall look at some particular issues raised by **international agency**, that is, where the agency relationship extends across national boundaries.

Study guide

		Intellectual level
C	**International business forms**	
1	**Agency**	
(a)	Define the role of the agent and give examples of such relationships paying particular regard to partners and company directors	2
(b)	Explain how the agency relationship is established	2
(c)	Define the authority of the agent	2
(d)	Explain the potential liability of both principal and agent	2

Exam guide

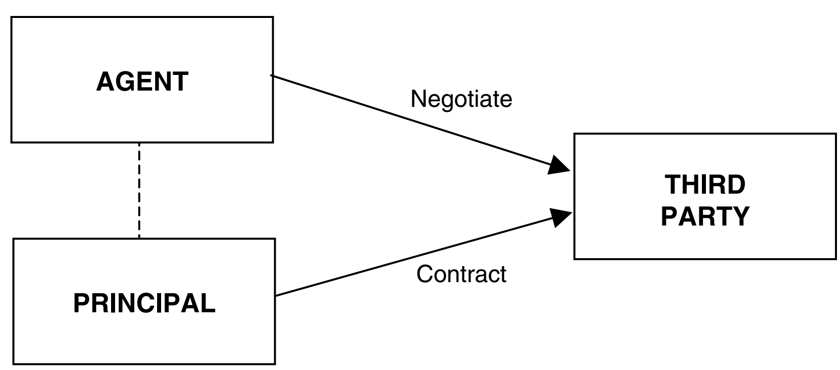
Agency may form a knowledge question, but it is equally likely to crop up in a question on partnership or company directors. It could also feature in a question on international business transactions.

1 Role of agency and agency relationships

FAST FORWARD

Agency is a relationship which exists between two legal persons (the **principal** and the **agent**) in which the function of the agent is to form a **contract between his principal and a third party**. Partners, company directors, factors, brokers and commercial agents are all acting as agents.

Agency is a very important feature of modern commercial life. It can be represented diagrammatically as follows:



For instance Pendo may ask Alan to take Pendo's shoes to be repaired. Pendo and Alan expressly agree that Alan is to do this on Pendo's behalf. In other words, Alan becomes her agent in making a contract between Pendo and Thierry, the shoe repairer, for her shoes to be mended.

1.1 Types of agent

In practice, there are many examples of agency relationships, to which you are probably aware of in everyday life, although you might not know that they illustrate the law of agency. The most important agency relationships for the F4 syllabus are those of partners and company directors.

Types of agent	
Partners	This is a particularly important example of agents in your syllabus, and we shall look at it in more detail in Chapter 8. For now, you should know that participants in a partnership (for example a firm of accountants) are agents of each other.
Company directors	This is another important example of agency in your syllabus. As we shall discuss in Chapter 15, directors act as agents of the company.
Factors	A factor, sometimes called a mercantile agent, is a person whose job is to sell or buy goods on behalf of another person. For example, motor dealers are often factors.
Brokers	A broker may operate in many trades. He is essentially an intermediary who arranges contracts in return for commission. For example, an insurance broker.
Auctioneers	Auctioneers are agents authorised to sell property at auction on behalf of the seller. When an auctioneer accepts a bid from a buyer, he becomes the agent of the buyer for the purpose of making a record of the sale.
Commercial agents	A commercial agent is an independent agent who has continuing authority in connection with the sale or purchase of goods.

2 Formation of agency

The law relating to the formation of agency will vary from country to country. However, some general principals that will be common to many national laws will be set out here. We shall also consider some specific requirements of some countries, as exemplar of requirements under the legal systems we outlined in Part A.

FAST FORWARD

The relationship of principal and agent is created by **mutual consent** in the vast majority of cases. This **agreement does not have to be formal, or written**.

The mutual consent comes about usually by **express agreement**, even if it is informal. However, it may also be **implied agreement**, due to the **relationship** or **conduct** of the parties.

2.1 Express agreement

This is where the agent is **expressly appointed** by the principal. This may be orally, or in writing. In most commercial situations, the appointment would be made in writing to ensure that everything was clear.

An agent expressly appointed by the principal has **actual authority**, which we shall look at in Section 3.

2.2 Implied agreement

An agency relationship between two people may be implied by their **relationship** or by their **conduct**.

2.2.1 Example: implied agency of spouses in Germany

German law provides that spouses are directly bound by one another's domestic transactions. There is therefore an implied agency relationship between spouses in domestic transactions.

2.2.2 Example: agency implied by employment relationship

An employee's duties involve him entering into contracts on his employer's behalf. Although an employer and employee are not automatically agents (in the way that partners are) an implied agency relationship exists between the employee (agent) and the employer (principal).

The authority of an implied agent may be different to the authority of an expressly appointed agent, as we shall discuss in Section 3.

2.3 Ratification of an agent's act: retrospective agreement

FAST FORWARD

A principal may subsequently **ratify** an act of an agent retrospectively.

An agency relationship may be created retrospectively, after the 'agent' has formed a contract on behalf of the 'principal'. Therefore it is created by the 'principal' **ratifying** the act of the 'agent'. If the principal agrees to the acts of the agent after the event, he may approve the acts of the agent and make it as if they had been principal and agent at the time of the contract.

The conditions for ratification are:

- The principal must have **existed** at the time of the contract made by the agent
- The principal must have had **legal capacity** at the time the contract was made
- The ratification must take place **within reasonable time**
- He ratifies the contract in its **entirety**
- He **communicates** his ratification to the third party sufficiently clearly

Once a contract has been ratified by the principal, the effect is that it is as if the agency relationship had been **expressly formed before** the contract made by the agent took place.

2.4 Formation of agency agreement without consent

FAST FORWARD

An agency may be created, or an agent's authority may be extended, without express consent. This happens **by estoppel**, when the principal **'holds out'** a person to be his agent, and when there is an **agent of necessity**.

2.4.1 Implied agreement

In some cases, an agency created by implied agreement might result in the agent having **more implied authority** than the principal might have consented to. Authority shall be discussed in Section 3.

2.4.2 Agent by estoppel

An agency relationship may be formed by implication when the **principal holds out to third parties** that a person is his agent, even if the principal and the 'agent' do not agree to form such a relationship. In such a case, the principal is estopped from denying the agent's apparent/ostensible authority (see Section 3), hence the name **'agent by estoppel'**. An agency relationship is not so formed if it is the 'agent' who creates the impression that a he is in an agency relationship with a 'principal'.

2.4.3 Agent by necessity

In some rare situations, it may be necessary for a person to take action in respect of someone else's goods in an **emergency situation**. That person can become an **agent of necessity** of the owner of the goods, as he takes steps in respect of the goods.

2.4.4 Example

A seller is shipping frozen goods to a buyer in another country. While the ship is docked, the freezers in the ship breakdown and the relevant part required to fix them cannot be obtained. If the ship's captain (acting as the agent of necessity) cannot make contact with the owner of the goods, he might, of necessity, sell the goods while they are still frozen, rather than allow them to spoil by defrosting.

This is particularly rare, because it would only occur when the 'agent' could not make contact with the 'principal', which in the modern world is **extremely unlikely**.

This principle is a historic part of English shipping and merchant law and you should be aware that it might be possible, but do not worry about the other details of the doctrine.

3 Authority of the agent

FAST FORWARD

If an agent acts within the limits of his authority, any contract he makes on the principal's behalf is **binding** on both principal and third party. The extent of the agent's authority may be **express, implied** or **ostensible**. Express and implied authority are both forms of **actual authority**.

A principal does not give the agent unlimited authority to act on his behalf. A **contract** made by the agent is **binding** on the principal and the other party **only if** the **agent was acting within the limits of his authority** from his principal. In analysing the limits of an agent's authority, three distinct sources of authority can be identified:

- Express authority
- Implied authority
- Ostensible authority

3.1 Express authority

Express authority is a matter between principal and agent. This is authority explicitly given by the principal to the agent to perform particular tasks, along with the powers necessary to perform those tasks.

The extent of the agent's express authority will depend on the **construction of the words used on his appointment**. If the appointment is in **writing**, then the document will need to be examined. If it is oral, then the scope of the agent's authority will be a matter of evidence.

If the agent contracts outside the scope of his express (actual) authority, he may be **liable** to the principal and the third party for **breach of warrant of authority**.

3.1.1 Example: express authority

A board of directors may give an individual direct express authority to enter the company into a specific contract. The company would be bound to this contract, but not to one made by the individual director outside the express authority.

3.2 Implied authority

Where there is no express authority, authority may be **implied** from the **nature** of the agent's activities or from **what is usual or customary in the circumstances**.

Between principal and agent the latter's express authority is paramount. The agent cannot contravene the principal's express instructions by claiming that he had implied authority for acting in the way he did.

As far as **third parties** are concerned, they are entitled to assume that the agent has implied usual authority unless they know to the contrary.

Watteau v Fenwick 1893

The facts: The owner of a hotel (F) employed the previous owner (H) to manage it. F forbade H to buy cigars on credit but H did buy cigars from W. W sued F who argued that he was not bound by the contract, since H had no actual authority to make it, and that W believed that H still owned the hotel.

Decision: it was within the usual authority of a manager of a hotel to buy cigars on credit and F was bound by the contract (although W did not even know that H was the agent of F) since his restriction of usual authority had not been communicated.

Hely-Hutchinson v Brayhead Ltd 1968

The facts: The chairman and chief executive of a company acted as its *de facto* managing director, but he had never been formally appointed to that position. Nevertheless, he purported to bind the company to a particular transaction. When the other party to the agreement sought to enforce it, the company claimed that the chairman had no authority to bind it.

Decision: Although the director derived no authority from his position as chairman of the board he did acquire authority from his position as chief executive. Therefore, the company was bound by the contract as it was within the implied authority of a person holding such a position.

3.3 Actual authority

Express and implied authority are sometimes referred to together as **actual authority**. This distinguishes them from **ostensible** or **apparent authority**, which is discussed next in this section.

Key term

Actual authority is a legal relationship between principal and agent created by a consensual agreement between them.

3.4 Apparent/ostensible authority

FAST FORWARD

An agent's **apparent** or **ostensible authority** may be greater than his express or implied authority. This occurs where the **principal** holds it out to be so to a third party, who relied on the representation and altered his position as a result. It may be **more extensive** than what is usual or incidental.

The **ostensible** (or **apparent**) authority of an agent is what a principal represents to other persons that he has given to the agent. As a result an agent (often by estoppel) with **express** or **implied** authority which are limited can be held in practice to have a more extensive authority.

Apparent/ostensible authority usually arises either:

(a) Where the **principal** has **represented** the agent as having authority even though he has not actually been appointed

(b) Where the **principal** has **revoked** the agent's **authority** but the **third party** has **not had notice** of this: *Willis Faber & Co Ltd v Joyce 1911.*

3.4.1 Example: apparent/ostensible authority

A principal employs a stockbroker to sell shares. It is an implied term of the arrangement between them that the broker shall (unless otherwise agreed) have **actual authority** to do what is usual in practice for a broker selling shares for a client (but no more than that). Any person dealing with the broker is entitled to assume (unless informed to the contrary) that the broker has the usual authority of a broker by his client.

3.4.2 The extent of ostensible authority

Ostensible authority (unlike implied authority) is not restricted to what is usual and incidental. The principal may expressly or by inference from his conduct **confer on the agent any amount of ostensible authority**.

3.4.3 Example: partnership

A **partner** has considerable but **limited implied authority** by virtue of being a partner. If, however, the other partners allow him to exercise greater authority than is implied, they have represented that he has a wider authority. They will be bound by the contracts which he makes within the limits of this **ostensible authority**.

3.4.4 Example: companies

Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd 1964

The facts: K and H carried on business as property developers through a company which they owned in equal shares. Each appointed another director, making four in all. H lived abroad and the business of the company was left entirely under the control of K. As a director, K had no actual or apparent authority to enter into contracts as agent of the company, but he did make contracts as if he were a managing director without authority to do so. The other directors were aware of these activities but had not authorised them. The claimants sued the company for work done on K's instructions.

Decision: there had been a representation by the company through its board of directors that K was the authorised agent of the company. The board had authority to make such contracts and also had power to delegate authority to K by appointing him to be Managing Director. Although there had been no actual delegation to K, the company had by its acquiescence led the claimants to believe that K was an authorised agent and the claimants had relied on it. The company was bound by the contract made by K under the principle of 'holding out' (or estoppel). The company was estopped from denying (that is, not permitted to deny) that K was its agent although K had no actual authority from the company.

It can be seen that it is the conduct of the 'principal' which creates ostensible authority. It does not matter whether there is a pre-existing agency relationship or not.

Exam focus point

This is important – ostensible authority arises in two distinct ways. It may arise where a **person makes a representation to third parties** that a particular person has the authority to act as their agent without actually appointing them as their agent. Alternatively, it may arise where a **principal has previously represented to a third party** that an agent has authority to act on their behalf.

3.4.5 Representations creating ostensible authority

The **representation must be made by the principal or an agent acting on his behalf.** It cannot be made by the agent who is claiming ostensible authority. *Armagas Ltd v Mundogas SA, The Ocean Frost 1986*.

It must be a **representation of fact, not law** and the representation must be **made to the third party**. This distinguishes ostensible authority from actual authority, where the third party need know nothing of the agent's authority.

3.4.6 Reliance on representations

It must be shown that the **third party relied on the representation**. If there is no causal link between the third party's loss and the representation, the third party will not be able to hold the principal as liable.

3.4.7 Example: reliance on representations

If the third party did not believe that the agent had authority or if they positively knew they did not then ostensible authority cannot be claimed. This is true even if the agent appeared to have authority.

3.4.8 Alteration of position following a representation

It is enough that the third party **alters his position as a result of reliance on the representation**. He does not have to suffer any detriment as a result, but damages would in such an event be minimal.

Question — **Ostensible authority**

Give three examples of occasions when ostensible authority may arise.

Answer

- Where a person allows another person, who is not his agent, to appear as if he is.
- Where a principal allows his agent to give the impression that he has more extensive authority than is really the case.
- Where, following termination of the agency relationship, a principal allows his former agent to continue to appear to be his agent.

3.5 Revocation of authority

Where a principal has represented to a third party that an agent has authority to act, and has subsequently **revoked the agent's authority**, this may be **insufficient to escape liability**. The principal should inform third parties who have previously dealt with the agent of the change in circumstances. This is particularly relevant to partnerships and the position when a partner leaves a partnership.

We shall look at partnership in the next chapter.

3.6 Termination of agency

FAST FORWARD

Agency is terminated by **agreement** or by **operation of law** (death, insanity, insolvency).

Agency is terminated when the **parties agree** that the relationship should end.

It may also be terminated by **operation of law** in the following situations:

- Principal or agent dies
- Principal or agent becomes insane
- Principal becomes bankrupt, or agent becomes bankrupt and this affects his position as agent

Termination brings the **actual authority** of the agent to an end. However, third parties are allowed to enforce contracts made later by the 'agent' until they are actively or constructively informed of the termination of the agency relationship.

4 Relations between agent and third parties

FAST FORWARD

An agent usually has **no liability** for a contract entered into as an agent, nor any **right to enforce it**. Exceptions to this: when an agent is **intended** to have liability; where it is **usual business practice** to have liability; when the agent is actually acting on his own behalf; where agent and principal have joint liability.

A third party to a contract entered into with an agent acting outside his ostensible authority can sue for breach of **warranty of authority**.

4.1 Liability of the agent for contracts formed

An agent contracting for his principal within his actual and/or apparent authority generally **has no liability** on the contract and **is not entitled to enforce it**. However, there are **circumstances** when the **agent will be personally liable** and can enforce it.

(a) When he **intended to undertake personal liability** – for example, where he signs a contract as party to it without signifying that he is an agent.

(b) Where it is **usual business practice or trade custom** for an agent to be liable and entitled.

(c) Where the agent **is acting on his own behalf** even though he purports to act for a principal.

Where an agent enters into a **collateral contract** with the third party with whom he has contracted on the principal's behalf, there is separate liability and entitlement to enforcement on that collateral contract.

It can happen that there is **joint liability** of agent and principal. This is usually the case where an agent did not disclose that he acted for a principal.

4.2 Breach of warranty of authority

An agent who **exceeds his ostensible authority** will generally have **no liability to his principal**, since the latter will not be bound by the unauthorised contract made for him. But the agent **will be liable** in such a case **to the third party** for breach of warranty of authority.

5 International agency

FAST FORWARD

As agency includes principal, agent and third party, there is great scope for **conflict of laws** in international agency. Unless the parties expressly agree the relevant law that governs their relationships, the **UN Model Law on Agency** will apply. The relevant law governing the principal's and agent's relationship may be different from that governing the agent's and the third party's relationship.

If an agency relationship is **international** in character, it will encounter the problem of **conflict of laws** that we discussed in the previous chapter. In the case of an agency relationship, the problem may be severe because, as we have seen in the rest of this chapter, there are many **legal complexities associated with the agency relationship**.

5.1 Examples of international agency

The Agent is from Country X and the Principal is from Country Y and the Agent is performing his duties in Country Z.

The Agent and the Principal are from Country X and the Agent is performing his duties in Country Y.

The examples show the complexities of the countries that could be involved in an agency relationship. You should also bear in mind that there are legal issues relating to several matters in an agency relationship:

- The **relationship** between the principal and the agent
- The **acts** carried out by the agent on behalf of the principal
- The relationship with **third parties** to the agency relationship

5.2 UN Model Law on Agency

These issues have been addressed in the **UN's Model Law on Agency** , which we shall look at now.

5.3 Parties agree relevant law

The first point to note about the Model law is that it allows the parties to an agency relationship to **expressly agree** what law should govern their relationship. The Model law states that the agent and principal may choose the national law which will govern their own relationship, so long as this agreement:

- Is **express** in their agreement
- Can be **inferred** with **reasonable certainty** from their agreement

In addition, the principal or the third party can expressly designate the national law which will govern the **actions of the agent**. This law will govern the actions, if the other party agrees to it.

One thing you should note, however, is that if any **state connected to the agency situation** has **mandatory rules** that are relevant to the agency situation, these will apply.

5.3.1 Example

If the country in which the agent was dealing with the third party required that contracts be in writing, the contract made between the agent (on behalf of the principal) and the third party should be in writing.

5.4 Parties do not agree relevant law

If the parties to an agency relationship do not make express agreement about what national law shall govern their relationship, the **Model law sets out the appropriate arrangements**.

5.4.1 Relationship between agent and principal

There are various rules about the relevant law that will govern the relationship between the agent and principal:

- **Basic rule**: Relevant law is the law of the state where the agent had his place of business at the formation of the agency relationship.
- **Exception**: If the agent is acting in the state where the principal has his place of business, the law of that state will apply to the agency relationship.

If parties do not have a 'place of business', the Model law provides that references to 'place of business' should be read as 'habitual residence'.

Additionally, where parties have more than one place of business, the one that should be used in the reckoning for this purpose is the one most closely connected to the relationship between agent and principal.

The **'relationship between agent and principal'** includes:

- The formation and validity of the relationship
- The obligations of both agent and principal
- Any conditions attached to the agent's performance of duties
- The consequences of non-performance of duties
- The end of the parties' obligations

5.4.2 Relationship between agent and third parties

Whatever law governs the performance of the agent's duties, the **law of the state** he is **acting in** will be **taken into account**.

There are various rules about the law that will govern the relationship between the agent and third parties, where no express agreement has been made.

(a) **Basic rule**: The agent's authority and its effect on third parties will be governed by the law of the **state in which the agent had his place of business** at the **time of the acts**.

(b) **Exceptions**:

  (i) If the agent has acted in the name of the principal in the country where the principal has his place of business

  (ii) If the agent has acted in any country where the principal has a place of business

  (iii) If the agent has acted at exchange or auction

  (iv) If the agent has no place of business of his own

  Rule: The applicable law will be the law of the state where the agent has acted.

There is one further complication demonstrated by the following example.

5.4.3 Example: relations between agent and third party

The agent is from a different country to the third party, but is in the third party's country. However, he has not dealt with him face-to-face, but by telephone.

In situations where the agent does not deal with the third party on a face to face basis, for example, by telephone, telex, e mail or other similar means **the effect is that it is as if the agent is in his own place of business**.

Therefore, the basic rule above will take effect.

Chapter Roundup

- **Agency** is a relationship which exists between two legal persons (the **principal** and the **agent**) in which the function of the agent is to form a **contract between his principal and a third party**. Partners, company directors, factors, brokers and commercial agents are all acting as agents.
- The relationship of principal and agent is created by **mutual consent** in the vast majority of cases. This **agreement does not have to be formal or written**.
- The mutual consent comes about usually by **express agreement**, even if it is informal. However, it may also be **implied agreement**, due to the **relationship** or **conduct** of the parties.
- A principal many later **ratify** an act of an agent retrospectively.
- An agency may be created, or an agent's authority may be extended, without express consent. This happens **by estoppel**, when the principal **'holds out'** a person to be his agent, and when there is an **agent of necessity**.
- If an agent acts within the limits of his authority, any contract he makes on the principal's behalf is **binding** on both principal and third party. The extent of the agent's authority may be **express, implied** or **ostensible**. Express and implied authority are both forms of **actual authority**.
- An agent's **apparent** or **ostensible authority** may be greater than his express or implied authority. This occurs where a **principal** holds it out to be so to a third party, who relied on the representation and altered his position as a result. It may be **more extensive** than what is usual or incidental.
- Agency is terminated by **agreement** or by **operation of law** (death, insanity, insolvency).
- An agent usually has **no liability** for a contract entered into as an agent, nor any **right to enforce it**. Exceptions to this: when an agent is **intended** to have liability; where it is **usual business practice** to have liability; when the agent is actually acting on his own behalf; where agent and principal have joint liability.

  A third party to a contract entered into with an agent acting outside his ostensible authority can sue for breach of **warranty of authority**.
- As agency includes principal, agent and third party, there is great scope for **conflict of laws** in international agency. Unless the parties expressly agree the relevant law that governs their relationships, the **UN Model Law on Agency** will apply. The relevant law governing the principal's and agent's relationship may be different from that governing the agent's and the third party's relationship.

Quick Quiz

1 **Fill in the gaps** using the words in the boxes below.

Agency is the…………………… which exists between two …………………… persons. They are ……………………...and the agent, in which the function of the agent is to form a ………………………….. between his …………………………. and a …………………………… .

(1)	relationship	(3)	contract	(5)	legal
(2)	third party	(4)	principal	(6)	principal

2 A principal may, in certain circumstances, ratify the acts of the agent which has retrospective effect.

True ☐

False ☐

3 What is the best definition of ostensible authority?

(a) The authority which the principal represents to other persons that he has given to the agent.

(b) The authority implied to other persons by the agent's actions.

4 Under the UN's Model Law on Agency, if the parties to an agency relationship expressly agree which nation's laws will govern their relationship, that agreement is effective.

True ☐

False ☐

5 What is the basic rule in the Model Law concerning which law will govern the relationship between agent and principal if they have not made an express agreement about governing law?

Answers to Quick Quiz

1 1, 5, 4 (6), 3, 6 (4), 2

2 True. Agents may ratify retrospectively.

3 (a). The key word is 'represents'.

4 True.

5 The relevant law is the law of the state where the agent had his place of business at the formation of the agency relationship.

Now try the question below from the Exam Question Bank

Number	Level	Marks	Time
Q8	Examination	10	18 mins

8 Sole traders and partnerships

Topic list	Syllabus reference
1 Sole traders	C2(a)
2 What is partnership?	C2(a)
3 Forming a partnership	C2(b)
4 Termination of partnership	C2(e)
5 Authority of partners	C2(c)
6 Liability of partners in an unlimited liability partnership	C2(d)
7 Alternative forms of partnership	C2(a)
8 Implications of international partnerships	C2(a)
9 Comparison of companies and partnerships	C2(a-e)

Introduction

Sole traders and partnerships are common forms of business organisation, although we shall see that the form of a partnership can vary across the world.

The key distinction between sole traders and partnerships, and companies, which we shall look at in this and the next chapter, is that sole traders and partnerships **do not generally have separate legal identity** from the people involved in them.

We shall look at how partnerships are **formed** and later **terminated**, then at how **relationships** with third parties work.

In Section 7, we shall look at some forms of partnership from different nations and legal systems around the world, and highlight some key factors that they possess.

We shall consider what happens when a partnership **extends over national boundaries**, for example, some of the largest accountancy firms extend around the world. Finally, we shall consider the issues that arise when deciding whether to trade as a **company** or a **partnership**.

Study guide

		Intellectual level
C2	**Partnerships**	
(a)	Demonstrate a knowledge of the legislation governing the partnership, both unlimited and limited	1
(b)	Discuss how partnerships are established	2
(c)	Explain the authority of partners in relation to partnership activity	2
(d)	Analyse the liability of various partners for partnership debts	2
(e)	Explain the way in which partnerships can be brought to an end	2

Exam guide

Partnership is the key type of organisation in this chapter and can form a question on its own. As partnerships are the form of organisation often used by accountants in practice, it will always be highly examinable. In addition, exam questions often look at contrasts between partnerships and companies as modes of organisation.

Statutory references in Chapters 8 to 16 are to the Companies Act 2006 unless otherwise stated.

Exam focus point

The examiner wrote an important article on the Companies Act 2006, published in the February and March 2008 editions of Student Accountant.

1 Sole traders

FAST FORWARD

In a **sole tradership**, there is no legal distinction between the individual and the business.

1.1 Introduction

A sole trader owns and runs a business. They contribute capital to start the enterprise, run it with or without employees, and earn the profits or stand the loss of the venture.

1.2 Legal status of the sole trader

Whilst the business is a separate accounting entity the business is **not legally distinct** from the person who owns it. In law, the person and the business are viewed as the same entity.

The **advantages** of being a sole trader are as follows.

(a) **No formal procedures** are required to set up in business. However, for certain classes of business a licence may be required (eg retailing wines and spirits), and VAT registration is often necessary.

(b) **Independence** and **self-accountability**. A sole trader need consult nobody about business decisions and is not required to reveal the state of the business to anyone (other than the tax authorities each year).

(c) **Personal supervision** of the business by the sole trader should ensure its effective operation. Personal contact with customers may enhance commercial flexibility.

(d) **All** the **profits** of the business **accrue** to the sole trader. This can be a powerful motivator, and satisfying to the individual whose ability/energy results in reward.

The **disadvantages** of being a sole trader include the following.

(a) If the business gets into debt, a sole trader's **personal wealth** (for example, private house) might be lost if the debts are called in, as they are the same legal entity.

(b) Expansion of the business is usually only possible by **ploughing back** the **profits** of the business as further capital, although loans or overdraft finance may be available.

(c) The business has a **high dependence** on the **individual** which can mean long working hours and difficulties during sickness or holidays.

(d) The **death** of the proprietor may make it **necessary** to **sell** the **business** in order to pay the resulting tax liabilities, or family members may not wish to continue the business anyway.

(e) The **individual** may **only have one skill**. A sole trader may be, say, a good technical engineer or craftsman but may lack the skills to market effectively or to maintain accounting records to control the business effectively.

(f) Other **disadvantages** associated with small size, lack of diversification, absence of economies of scale and problems of raising finance and so on.

2 What is partnership?

FAST FORWARD

Partnership is 'the relation which subsists between persons carrying on a business in common with a view of profit'. A traditional partnership is **not** a separate legal person distinct from its members, it is **merely** a 'relation' between persons.

Partnership is a common form of business association. It is **flexible**, because it can either be a **formal** or **informal** arrangement, so can be used for large organisations or a small husband and wife operation.

Partnership is normal practice in the **professions** as most professions prohibit their members from carrying on practice through limited companies, though some professions permit their members to trade as limited liability partnerships which have many of the characteristics of companies. Business people are not so restricted and generally prefer to trade through a limited company for the advantages this can bring.

Exam focus point

Your syllabus requires you to demonstrate knowledge of the legislation governing both limited and unlimited liability partnerships. You should therefore make careful note of the rules regarding the Partnership Act 1890, the Limited Partnership Act 1907 and the Limited Liability Partnership Act 2000.

2.1 Definition of partnership

Key term

'**Partnership** is the relation which subsists between persons carrying on a business in common with a view of profit': s 1 Partnership Act 1890.

We shall look at some points raised by this definition now.

2.1.1 The relation which subsists between persons

'Person' includes a corporation such as a **registered company** as well as an **individual** living person.

There must be at least **two** partners. If, therefore, two men are in partnership, one dies and the survivor carries on the business he is a sole trader. There is no longer a partnership.

2.1.2 Carrying on a business

Business can include every trade, occupation or profession, but three points should be noted.

(a) A business is a **form of activity**. If two or more persons are merely the passive joint owners of revenue-producing property, such as rented houses, that fact does not make them partners.

(b) A business can consist of a **single transaction**. These situations are often described as 'joint ventures'

(c) Carrying on a business must have a **beginning and an end**. A partnership begins when the partners agree to conduct their **business activity** together. This can be before the business actually begins to trade, such as when premises are leased and a bank account opened: *Khan v Miah 2001*.

2.1.3 In common

Broadly this phrase means that the partners must be associated in the business as **joint proprietors**. The evidence that this is so is found in their taking a share of the profits, especially **net profit**.

2.1.4 A view of profit

If persons enter into a partnership with a **view to making profits** but they actually suffer losses, it is still a partnership. The test to be applied is one of **intention**. If the intention of trading together is just to gain experience, for example, there is no partnership: *Davies v Newman 2000*.

2.2 Consequences of the definition

In most cases there is no doubt about the existence of a partnership. The partners declare their intention by such steps as signing a **written partnership agreement** and adopting a **firm name**. These outward and visible signs of the existence of a partnership are not essential - a partnership can exist without them.

2.3 Terminology

The word 'firm' is correctly used to denote a partnership. It is **not** correct to apply it to a registered company (though the newspapers often do so).

The word 'company' may form part of the name of a partnership, for example, 'Smith and Company'. But 'limited company' or 'registered company' is **only** applied to a properly registered company.

3 Forming a partnership

FAST FORWARD

Partnerships can be **formed** very informally, but there may be complex formalities to ensure clarity.

A partnership can be a very **informal arrangement**. This is reflected in the procedure to form a partnership.

A partnership is **formed when two or more people agree to run a business together**. Partnerships can be formed in any trade, occupation or profession.

In order to be a partnership, the business must be **'carried on in common'**, meaning that all parties must have **responsibility** for the business. In other words, there is **more than one proprietor**.

A husband and wife who run a shop together are partners, a shop owner and his employee are not.

In law then, the formation of a partnership is essentially straightforward. People **make an agreement** together to run a business, and **carry that agreement out**.

Question

Imagine that two large firms of accountants wanted to merge. The partners agreed on 1 June 20X7 that they would merge and become a new partnership, known as the Biggest Accountancy Partnership. In law, this is straightforward.

What problems do you think they might encounter?

Answer

In law, when the partners agree to form a new partnership, then they have a new partnership.

In practice, however, if two massive businesses such as two large firms decided to merge, the details of the formation of the new partnership would be far more complex than that. Here is a list of just some of the things that they would have to consider.

- Profit share
- Employees
- Partnership property
- Partner hierarchy
- Recruitment policy
- Future partners' policy
- Standard partners authority to act in the new firm's name
- Fair trading and monopoly issues

In practice, the formation of such a new partnership would be an enormous operation.

3.1 Common formation formalities

In practice, the formalities of setting up a partnership may be more **complex** than simple agreement. Many professional people use partnerships. These business associations can be vast organisations with substantial revenue and expenditure, such as the larger accountancy firms and many law firms.

Such organisations have so many partners that the relationships between them has to be **regulated**. Thus forming some partnerships can involve creating **detailed partnership agreements** which lay out terms and conditions of partnership.

3.1.1 The partnership agreement

A written partnership agreement is *not* legally required. In practice there are advantages in setting down in writing the terms of their association.

(a) It **fills** in the **details** which the law would not imply – the nature of the firm's business, its name, and the bank at which the firm will maintain its account for instance.

(b) A written agreement serves to **override terms** otherwise implied by the Partnership Act 1890 which are inappropriate to the partnership. The Act for example implies that partners share profits equally.

(c) Additional clauses can be developed. **Expulsion clauses** are an example and they provide a mechanism to expel a partner where there would be no ability to do so otherwise.

3.2 Supervision and regulation

There is no formal statutory supervision or regulation of partnerships. Their accounts need not be in prescribed form nor is an audit necessary. The public has no means or legal right of inspection of the firm's accounts or other information such as companies must provide.

If, however, the partners carry on business under a firm name which is not the surnames of them all, say, 'Smith, Jones & Co', they are required to disclose the **names** of the **partners** on their letterheads and at their places of business. They are required to make a **return** of their **profits** for income tax and **usually** to **register** for VAT.

3.3 Property

Partnerships **can** grant a **mortgage** or **fixed charge** over property, but **cannot** grant **floating changes** (see Chapter 13).

4 Termination of partnership

FAST FORWARD

Partnerships may be **terminated** by passing of time, termination of the underlying venture, death or bankruptcy of a partner, illegality, notice, agreement or by order of the court.

Termination is when the partnership comes to an end. In this context, 'partnership' means the existing partners.

4.1 Example: termination of a partnership

Alison, Ben, Caroline and David are in partnership as accountants. Caroline decides to change career and become an interior designer. In her place, Alison, Ben and David invite Emily to join the partnership.

As far as third parties are concerned, a partnership offering accountancy services still exists. In fact, however, the old partnership (ABCD) has been dissolved, and a new partnership (ABDE) has replaced it.

4.2 Events causing termination

Partnership is terminated in the following instances.

- **Passing of time**, if the partnership was entered into for a fixed term
- **Termination of the venture**, if entered into for a single venture
- The **death or bankruptcy** of a partner (partnership agreement may vary)
- **Subsequent illegality**
- **Notice** given by a partner if it is a partnership of indefinite duration
- **Order of the court** granted to a partner
- **Agreement** between the partners

In the event of the **termination** of a partnership, the partnership's **assets are realised** and the proceeds applied in this order.

- Paying off external debts
- Repaying to the **partners** any loan **advances**
- Repaying the partners' **capital contribution**
- Anything left over is then **repaid** to the **partners** in the **profit sharing ratio**.

The partnership agreement can exclude some of these provisions and can **avoid dissolution** in the following circumstances.

- Death of a partner
- Bankruptcy of a partner

It is wise to make such provisions to give **stability** to the partnership.

5 Authority of partners

FAST FORWARD

The key issues in a partnership include: partners' **authority to contract**, and **liability of partners** for the acts of fellow partners.

You learnt about agency in Chapter 7. The authority of partners to bind each other in contract is based on the principles of agency.

In simple terms, a partner is the **agent of the partnership and his co-partners**. This means that some of his acts bind the other partners, either because they have, or because they appear to have, authority. The UK's **Partnership Act 1890 defines** the **authority** of a partner to make contracts as follows.

> **Authority of a partner**
>
> Every partner is an **agent** of the firm and his other partners for the purpose of the business of the partnership, and the acts of every partner who does any act for carrying on the **usual way** of business if the kind carried on by the firm of which he is a member **bind the firm** and his partners, **unless** the partner so acting has **in fact no authority** to act for the firm in the particular matter, **and the person with whom he is dealing** either **knows that he has no authority**, or does not know or believe him to be a partner.
>
> Where a partner pledges the credit of the firm for a **purpose apparently not connected** with the firm's ordinary course of business, the **firm is not bound, unless** he is in fact **specially authorised** by the other partners: but this section does not affect any personal liability incurred by an individual.
>
> If it has been **agreed between the partners** that any **restriction** shall be placed on the power of any one or more of them to bind the firm, **no act** done in contravention of the agreement is **binding** on the firm with respect to **persons having notice of the agreement.**

The key point to note about authority of partners is that, other than when the partner has actual authority, the authority often **depends on the perception of the third party**. If the third party genuinely believes that the partner has authority, the partner is likely to bind the firm.

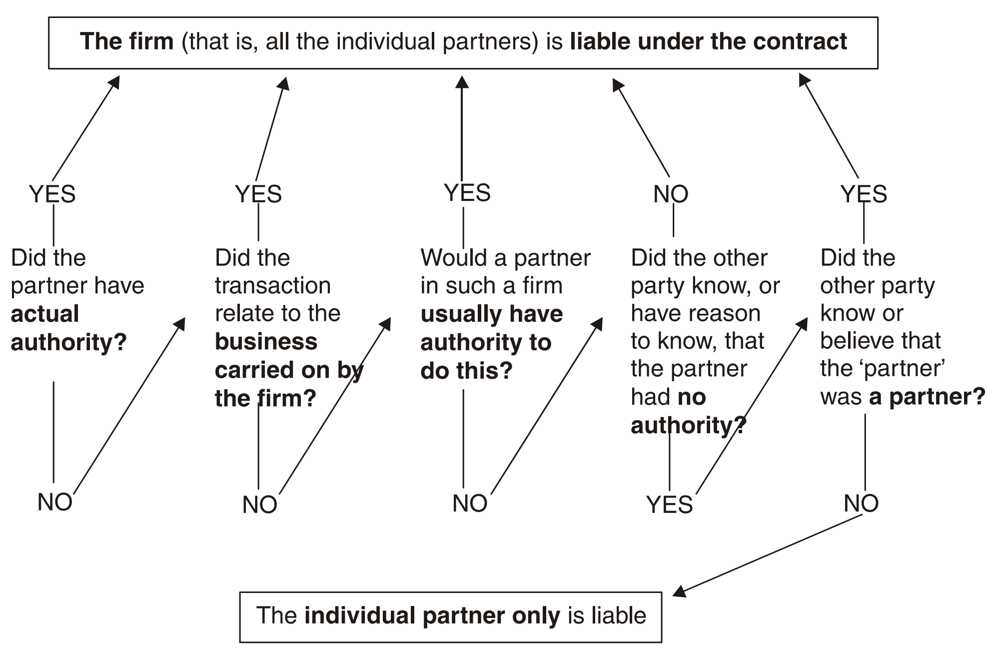
Partners are also **jointly liable** for **crimes** and **torts** committed by one of their number in the course of business.

6 Liability of partners in an unlimited liability partnership

FAST FORWARD

> Partners are **jointly liable**, for all partnership debts that result from contracts made by other partners which bind the firm.

Partners are **jointly liable** for all partnership debts that result from contracts made by other partners which bind the firm. The **Civil Liability Act 1978** provides that judgement against one partner does not prevent subsequent actions against other partners. The link between authority and liability can be seen in the following diagram.



There are particular rules on liability for new and retiring partners.

Partner	Partner liability
New partners	A new partner admitted to an existing firm is liable for **debts incurred** only **after** they become a partner. They are not liable for debts incurred before they were a partner unless they agree to become liable.
Retiring partners	A partner who retires is still **liable** for any **outstanding debts** incurred while they were a partner, unless the creditor has agreed to release them from liability. They are also **liable** for debts of the firm **incurred after their retirement** if the creditor knew them to be a partner (before retirement) and has not had **notice** of their retirement. Therefore, it is **vital** on retirement that a partner **gives notice** to all the creditors of the firm. The retiring partner may have an indemnity from the remaining partners with respect to this issue.

7 Alternative forms of partnership

FAST FORWARD

As well as traditional UK partnerships, there are other models in operation around the world. Some allow **limited liability** for partners, **limited membership**, liability only for one's **own debts** and contracts, and **dormant** or **sleeping** partnerships.

The model of **unlimited liability partnership** we have looked at so far is the model in England, which is frequently used elsewhere in the world. There are some alternatives to the basic English model.

7.1 Limited liability partnerships (LLPs)

The other form of partnership commonly used in England, particularly for professional partnerships, is the **limited liability partnership (LLP)**. This type of business association was created by the Limited Liability Partnership Act 2000. LLPs are similar to limited companies in that they have separate legal identity and unlimited liability for debts, but the liability of the individual partners is **limited to the amount of their capital contribution**.

LLPs have similar requirements for governance and accountability as limited companies. They are generally set up by firms of professionals such as accountants and lawyers, who are required by the rules of their professions to operate as partnerships but who seek to have the protection of limited liability.

7.2 Formation

A limited liability partnership may be formed by persons associating to carry on lawful business with a view to profit, but it **must be incorporated** to be recognised. LLPs can have an unlimited number of partners. To be incorporated, the subscribers must send an **incorporation document** and a **statement of compliance** to the Registrar of Companies.

The document must be signed and state the following:

- The **name** of the LLP
- The **location** of its **registered office** (England and Wales/Wales/Scotland)
- The **address** of the registered office
- The name and address of all the **members** of the LLP
- Which of the members are to be **designated members** (see below)

There is also a registration fee of £95.

7.3 Internal regulation

LLPs are more flexible than companies as they provide similar protection for the owners, but with less statutory rules on areas such as meetings and management. No board of directors is needed. As can be seen in the incorporation procedures, LLPs come under the supervision of the **Registrar of Companies** (the Registrar).

The members of the LLP are those who subscribe to the original incorporation document, and those admitted afterwards in accordance with the terms of the partnership agreement.

The rights and duties of the partners will usually be set out in a **partnership agreement**. In the absence of a partnership agreement, the rights and duties are set out in regulations under the Act.

LLPs must have **two designated members**, who must take responsibility for the publicity requirements of the LLP.

With regard to publicity, the LLP's designated members must:

- **File** certain notices with the Registrar, such as when a member leaves
- Sign and file **accounts**
- Appoint **auditors** if appropriate

The Registrar will maintain a file containing the publicised documents of the LLP at Companies House.

7.4 External relationships

Every member is an **agent** of the LLP. As such, where the member has authority, the LLP will be bound by the acts of the member.

The **LLP will not be bound by the acts of the member where:**

- They have no authority and the third party is aware of that fact
- They have ceased to be a member, and the third party is aware of that fact

7.5 Dissolution

An LLP **does not dissolve on a member leaving** it, in the same way that a traditional partnership does. Where a member has died or (for a corporate member) been wound up, that member ceases to be a member, but the LLP continues in existence.

An **LLP must therefore be wound up** when the time has come for it to be dissolved. This is achieved under provisions **similar to company winding up** provisions (see Chapter 17).

7.6 Limited partnership

The other form of partnership that is seen, rarely, in the UK is the **limited partnership**. Under the Limited Partnership Act 1907, a partnership may be formed in which at least one partner (the general partner) must have **full, unlimited liability**. The other partners have **limited liability** for the debts of the partnership beyond the extent of the capital they have contributed. The rules are as follows.

- Limited partners may not withdraw their capital
- Limited partners may not take part in the management of the partnership
- Limited partners cannot bind the partnership in a contract with a third party without losing the benefit of limited liability
- The partnership must be registered with Companies House

Exam focus point

Partnership questions in scenarios often revolve around a partner's authority to enter contracts and the liability of all the partners when debts are incurred. This was the case in June and December 2008.

Question

LLPs

Explain the publicity requirements that LLPs must meet.

Answer

The designated members must:

- File certain notices with the Registrar
- Sign and file accounts
- Appoint auditors if appropriate

7.7 Partnerships in France

Partnerships as distinct from companies are not recognised as such in French law. Rather, the distinction that is made is whether a person or persons are **acting for commerce**.

If a person or group is engaged in commercial activity (and is therefore designated a **commerçant)**, he automatically comes under certain requirements of French law:

- To maintain proper books of account
- To record particulars in the commercial register

If people join together to engage in acts of commerce for the purposes of profit, they become a **société**. French sociétés loosely align to what are known as partnerships and companies in England.

The sociétés that most resemble partnerships in England are:

- **Société en nom collectif** (similar to a traditional English partnership)
- **Société en commandite simple**

A **société en commandite simple** is distinguished from the other type by having some **'limited' members**, known as commanditaires. These people are not actively involved in the business except in terms of the investment they have made.

Exam focus point

You must not confuse this concept of 'limited membership' with the doctrine of limited liability for company members which we shall look at in Chapter 9.

7.8 Muslim partnerships

There are various types of partnership, that is profit-sharing enterprises, in Muslim law:

- Shirkah al-'Inan
- Mudaraba
- Musharakah

The **Shirkah al-Inan** is an arrangement where partners contribute capital, property or labour and share profits as agreed between them. It differs from a traditional English partnership in that **partners** are **not liable** for **each other's debts**, and each partner can only sue on a contract he has made.

The **Mudaraba** is a form of dormant partnership. It is similar to the French société en commandite simple, where one person gives capital to an active partner on the basis that the lender will share in the active partner's profits. This may sound as though the dormant partner has simply given the active partner a loan. However, remember that **riba** (interest), is forbidden in Muslim law, so a dormant partner arrangement avoids this problem.

The **Musharakah** is the most similar to the English traditional partnership, where partners combine resources to invest in an enterprise, then sharing decision making and profits.

8 Implications of international partnerships

FAST FORWARD

Professional people often have to use the partnership form. Global partnerships carry **risks** for partners, so an international affiliation of national partnerships often is used.

As we have seen from the rest of this chapter, the partnership is an agency relationship. Therefore, the **problems** associated with **international agency relationships** discussed in Chapter 7 will be relevant here.

Most large multi-national businesses are likely to incorporate due to their size, and therefore trade as companies, not partnerships. However, some of the largest partnerships, as we discussed earlier in this Chapter, are firms of **professional people**. This is often because their professional body, for example, ACCA, does not permit them to trade through a company.

Large professional partnerships such as accountants and lawyers may therefore cross national boundaries. When the enterprise is so large, the issue of **joint liability** is a serious one. In theory, a partner in one country could be fully personally liable for the negligence of someone in another country who is bound by **different legal standards and requirements**.

In recent times, some accountancy firms have been afflicted by serious bankruptcy problems in the wake of **legal action** and associated **bad publicity**. Such a climate is a significant problem for partnerships, where partners in one country can be affected by events in another country that is subject to different regulations.

There are various ways of avoiding this problem in practice.

Most of the larger accountancy firms are a **collection of legal entities** in the different nations which are **affiliated** to each other, but that legally are not part of the same legal entity.

This could be achieved by all the different legal entities being connected by virtue of all being a member of **one overall legal entity**, or by the **different legal entities contracting with each other**.

8.1 Example: Big Four accountancy firms

PricewaterhouseCoopers is an international accountancy firm. It consists of different legal entities in different countries, which are all members of PricewaterhouseCoopers International Limited, a company incorporated in the UK.

Similarly **KPMG**, another major international accountancy firm, is a collection of legal entities, affiliated by virtue of being members of KPMG International, a Swiss association.

The distinguishing feature of this form of association is that the **individual firms** are all **part** of the **international concept** that is the **global firm**. Each national firm is a part of the whole, although it is legally a separate entity.

In effect, the different firms are branches of the same firm around the world, for example, KPMG LLP, a US limited partnership, or KPMG LLP, a limited liability partnership registered in England and Wales.

Some partnerships that are not so big choose not to affiliate to this extent, but rather to **form alliances** with one another, so that the practical effect is similar, but they do not use global branding to the same extent.

8.2 Example: Medium-sized accountancy firm

Baker Tilly International is an organisation to which accountancy firms in many nations are affiliated. Baker Tilly itself is a UK partnership affiliated to the international organisation, which has many other worldwide firms affiliated to it, such as Morrison Murray (Durban, South Africa) and Gomez Partners & Co (Nassau, Bahamas).

Baker Tilly is a trademark belonging to the UK partnership, and if the associated firms use it, they must do so under licence from the UK firm.

Both these approaches to global representation are also used by law firms. However, some law firms trade globally through **single partnerships**.

9 Comparison of companies and partnerships

FAST FORWARD

There is a clear **distinction** between **partnerships** and **companies**. The choice of vehicle will be determined by a number of factors.

We shall study companies in the next chapter, but for now it will be useful to consider a number of key differences between companies and partnerships. Do not worry if you do not understand some of the terms, we shall be covering them in the coming chapters.

Revisit this table during your revision as exam questions may ask you to describe the distinction between these two types of business organisation.

The most important difference between a company and a partnership is that a company has a **separate legal personality** from its members, while a traditional partnership does not.

This basic quality of a company gives rise to a number of characteristics which mark it out from a partnership. These are outlined below. The other key differences relate to the **formality** of a company as opposed to a partnership and the **regulations** it has to adhere to.

Factor	Company	Partnership
Entity	Is a legal entity separate from its members	Has no existence outside of its members.
Liability	Members' liability can be limited	Partners' liability is usually unlimited
Size	May have any number of members (at least one)	Some partnerships are limited to twenty members (professional partnerships excluded)
Succession	Perpetual succession – change in ownership does not affect existence	Traditional partnerships are dissolved when any of the partners leaves
Owners' interests	Members own transferable shares	Partners cannot assign their interests in a partnership
Assets	Company owns the assets	Partners own assets jointly
Management	Company must have at least one director (two for a public company)	All partners can participate in management
Constitution	Company **must** have a written constitution.	A partnership **may** have a written partnership agreement
Accounts	A company must usually deliver accounts to the Registrar	Partners do not have to send their accounts to the Registrar
Security	A company may offer a floating charge over its assets	A partnership may not usually give a floating charge over its assets
Withdrawal of capital	Strict rules concerning repayment of subscribed capital	More straightforward for a partner to withdraw capital
Taxation	Company pays tax on its profit Directors are taxed through PAYE system Shareholders receive dividends which are taxed 10 months after the tax year	Partners extract 'drawings' weekly or monthly. No tax is deducted. Income tax is payable on their share of the final profit for the year
Management	Members elect directors to manage the company	All partners have a right to be involved in management

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Chapter Roundup

- In a **sole tradership**, there is no legal distinction between the individual and the business.
- Partnership is 'the relation which subsists between persons carrying on a business in common with a view of profit'. A traditional partnership is **not** a separate legal person distinct from its members, it is **merely** a 'relation' between persons.
- Partnerships can be **formed** very informally, but there may be complex formalities to ensure clarity.
- Partnerships may be **terminated** by passing of time, termination of the underlying venture, death or bankruptcy of a partner, illegality, notice, agreement or by order of the court.
- The key issues in a partnership include: partners' **authority to contract**, and **liability of partners** for the acts of fellow partners.
- Partners are **jointly liable**, for all partnership debts that result from contracts made by other partners which bind the firm.
- As well as traditional UK partnerships there are other models in operation around the world. Some allow **limited liability** for partners, **limited membership**, liability only for one's **own debts** and contracts and **dormant** or **sleeping** partnerships.
- Professional people often have to use the partnership form. Global partnerships carry **risks** for partners, so an international affiliation of national partnerships is often used.
- There is a clear **distinction** between **partnerships** and **companies**. The choice of vehicle will be determined by a number of factors.

Quick Quiz

1 Define partnership.

2 A partnership is formed when parties agree to run a business in common.

True ☐

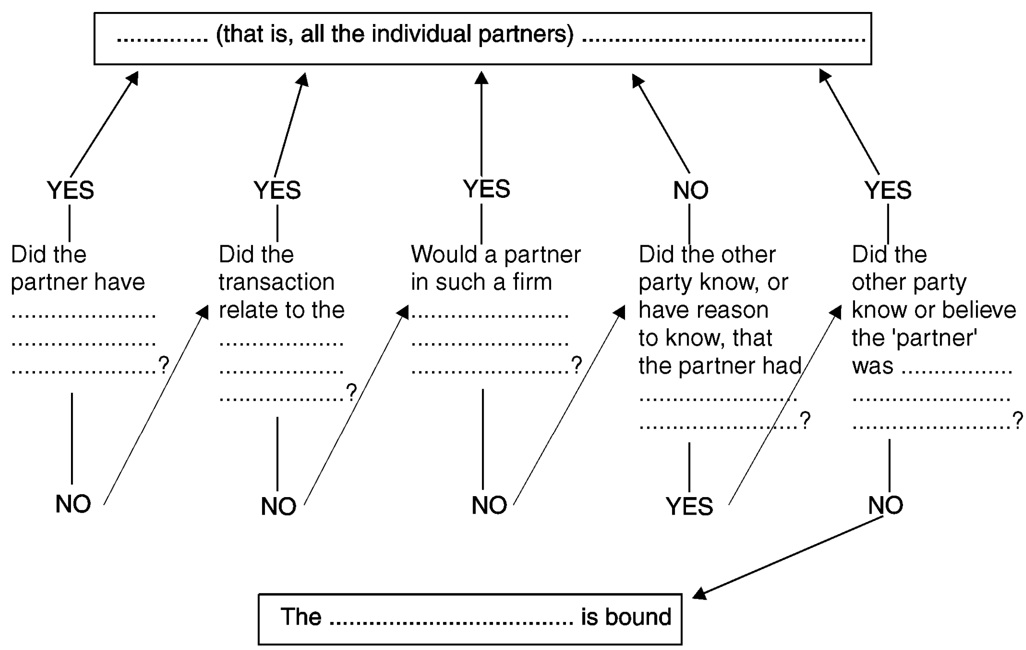
False ☐

3 List any five circumstances that will terminate a partnership.

4 In a limited partnership how many partners must have unlimited liability?

(a) One
(b) Two
(c) Twenty
(d) None

5 Complete the diagram showing partners' liability.



Answers to Quick Quiz

1 Partnership is the relation which subsists between persons carrying on a business in common with a view of profit.

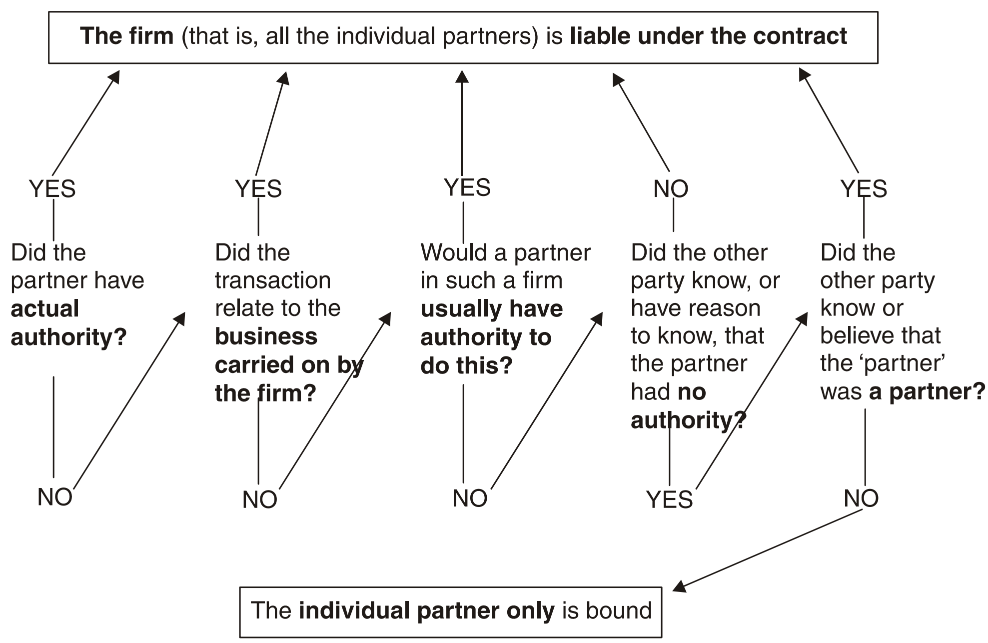
2 True. Partnerships begin when two or more parties agree to run a business together.

3 Any five from the following:

- **Passing of time**, if the partnership was entered into for a fixed term
- **Termination of the venture**, if entered into for a single venture
- The **death or bankruptcy** of a partner (partnership agreement may vary)
- **Subsequent illegality**
- **Notice** given by a partner if it is a partnership of indefinite duration
- **Order of the court** granted to a partner
- **Agreement** between the partners

4 (a). At least one partner must have unlimited liability in a limited partnership.

5



Now try the question below from the Exam Question Bank

Number	Level	Marks	Time
Q9	Examination	10	18 mins

PART D

Joint stock companies

9

Corporations and legal personality

Topic list	Syllabus reference
1 A company's legal identity	D1(a)
2 Limited liability of members	D1(b)
3 Types of company	D1(c)
4 Additional classifications	D1(c)
5 Effect of legal personality	D1(d)
6 Ignoring legal personality	D1(e)
7 Other corporate forms	D1(c)

Introduction

The most popular vehicle for business in the world is the **corporate form**, the joint stock company. Companies are found in most countries of the world.

We shall again be using the English model of companies to look at the corporate form. However, we shall also consider some of the features of companies from different countries.

The key difference between partnerships and companies in the English form is the concept of **separate legal personality**. This chapter outlines this doctrine, and also discusses its implications (primarily **limited liability** for members) and the exceptions to it (lifting the **veil of incorporation**).

We shall look at the different types of company that exist in English law in Section 3, and then go on to compare and contrast them to some other corporate forms found in the world in Section 7.

Study guide

		Intellectual level
D	**The formation and constitution of joint stock companies**	
1	**Corporations and legal personality**	
(a)	Distinguish between sole traders, partnerships and companies	2
(b)	Explain the meaning and effect of limited liability	2
(c)	Analyse different types of companies, especially private and public companies	2
(d)	Illustrate the effect of separate personality	2
(e)	Recognise instances where separate personality will be ignored	2

Exam guide

You must be able to **compare and contrast companies and partnerships**, which we introduced in the previous chapter. You must also be able to advise parties starting up in business which would be the best form of business organisation for them.

The corporate form is a key exam topic. You should bear that in mind when working through this chapter and the next three chapters of the Study Text.

1 A company's legal identity

FAST FORWARD

A company has a **legal personality** separate from its owners (known as members). It is a formal arrangement, surrounded by formality and publicity, but its chief advantage is that members' liability for the company's debts is typically limited.

A company is the most popular form of business association.

By its nature, a company is more **formal** than a partnership or a sole trader. There is substantially **more legislation** on the formation and procedures of companies than any other business association, hence the weighting towards company law of the rest of this Study Text.

The key reason why the company is a popular form of business association is that the **liability of its members to contribute to the debts of the entity is significantly limited**. This will be explained more later in this chapter. For many people, this benefit outweighs the disadvantage of the formality surrounding companies, and encourages them not to trade as sole traders or (unlimited) partnerships.

1.1 Definition of a company

Key terms

For the purposes of this Study Text, a **joint stock company** is an entity so registered under the law. In the UK this would be the Companies Act 2006.

The key feature of a company is that it has a **legal personality** (existence) distinct from its members and directors.

1.2 Legal personality

A person possesses legal rights and is subject to legal obligations. In law, the term person is used to denote two categories of legal person.

(a) An individual human being is a **natural person**. A sole trader is a natural person, and there is legally no distinction between the individual and the business entity in sole tradership

(b) The law also recognises **artificial persons** in the form of companies.

Key term

> **Corporate personality** is a common law principle that grants a company a legal identity, separate from the members who comprise it. It follows that the property of a company belongs to that company, debts of the company must be satisfied from the assets of that company, and the company has perpetual succession until wound up.

A corporation is a **legal entity** separate from the natural persons connected with it, for example as members or directors. We shall come back to this later.

2 Limited liability of members

FAST FORWARD

> The fact that a **company's members** – not the company itself – have limited liability for its debts protects the members from the company's creditors and ultimately from the full risk of business failure.

A key consequence of the fact that the company is distinct from its members is that its members therefore have **limited liability.**

Key term

> **Limited liability** is a protection offered to members of certain types of company. In the event of business failure, the members will only be asked to contribute identifiable amounts to the assets of the business.

2.1 Protection for members against creditors

The **company** itself is **liable without limit for its own debts.** If the company buys plastic from another company, for example, it owes the other company money.

Limited liability is a benefit to members. They own the business, so might be the people who the creditors logically asked to pay the debts of the company if the company is unable to pay them itself.

Limited liability prevents this by stipulating the **creditors** of a limited company **cannot demand payment of the company's debts** from members of the company.

2.2 Protection from business failure

As the company is liable for all its own debts, limited liability only becomes an issue in the event of a business failure when the **company is unable to pay its own debts**.

This will result in the **winding up** of the company which will enable the creditors to be paid from the proceeds of any assets remaining in the company. It is at winding up that limited liability becomes most relevant.

2.3 Members asked to contribute identifiable amounts

Although the creditors of the company cannot ask the members of the company to pay the debts of the company, there are some amounts that **members are required to pay, in the event of a winding up**.

Type of company	Amount owed by member at winding up
Company limited by shares	Any **outstanding amount** from when they originally purchased their shares. If the member's shares are fully paid, they **do not have to contribute anything in the event of a winding up**.
Company limited by guarantee	The **amount they guaranteed** to pay in the event of a winding up

Question

Hattie and two friends wish to set up a small business. Hattie is concerned that, following her initial investment, she will have no access to additional funds, and is worried what might happen if anything goes wrong. Advise her on the relative merits of a company and an unlimited partnership.

Answer

The question of liability appears to be important to Hattie. As a member of a limited company, her liability would be limited – as a member at least – to any outstanding amount payable on her shares. If the three friends decide to form an unlimited partnership, they should be advised that they will have **unlimited** liability for the debts of the partnership. (An unlimited partnership does **not** have a legal personality distinct from the partners).

2.4 Liability of the company for tort and crime

As a company has a separate legal identity, it may also have liabilities in **tort** and **crime**. Criminal liability of companies in particular is a topical area but, is outside the scope of your syllabus.

3 Types of company

Corporations are classified in one of the following categories.

Categories	Description
Corporations sole	A corporation sole is an **official position** which is filled by one person who is replaced from time to time. The Public Trustee and the Treasury Solicitor are corporations sole.
Chartered corporations	These are usually **charities** or bodies such as the Association of Chartered Certified Accountants, formed by Royal Charter.
Statutory corporations	Statutory corporations are formed by special Acts of Parliament. This method is little used now, as it is slow and expensive. It was used in the nineteenth century to form railway and canal companies.
Registered companies	Registration under the Companies Act is the normal method of incorporating a commercial concern. Any body of this type is properly called a company.
Community Interest Companies (CICs)	A special form of company for use by 'social' enterprises pursuing purposes that are beneficial to the community, rather than the maximisation of profit for the benefit of owners.

3.1 Limited companies

FAST FORWARD

A company member's liability may be limited by **shares** or by **guarantee**, or it may be **unlimited**.

The meaning of limited liability has already been explained. It is the **member**, not the company, whose liability for the company's debts may be limited.

3.1.1 Liability limited by shares

Liability is usually **limited by shares.** This is the position when a company which has share capital states in its constitution that 'the liability of members is limited'.

3.1.2 Liability limited by guarantee

Alternatively a company may be **limited by guarantee**. Its constitution states the amount which each member **undertakes** to **contribute** in a winding up (also known as a liquidation). A creditor has no direct claim against a member under his guarantee, nor can the company require a member to pay up under his guarantee until the company goes into liquidation.

Companies limited by guarantee are appropriate to **non-commercial activities**. For example, a charity or a trade association which is non-profit making but wishes to have the members' guarantee as a form of reserve capital if it becomes insolvent. They do **not** have **share capital**.

3.2 Unlimited liability companies

Key term

An **unlimited liability company** is a company in which members do not have limited liability. In the event of business failure, the liquidator can then require members to contribute as much as may be required to pay the company's debts in full.

An unlimited company **can only be a private company**, as by definition, a **public company is always limited**.

An unlimited company need not **file** a copy of its **annual accounts** and reports with the Registrar, unless during the relevant accounting reference period:

(a) It is (to its knowledge) a **subsidiary** of a limited company.

(b) **Two** or more **limited companies** have **exercised rights** over the **company**, which (had they been exercised by only one of them) would have **made** the **company** a **subsidiary** of that one company.

(c) It is the **parent company** of a limited liability company.

Question — Limited liability

Explain the liability of members of companies limited by guarantee.

Answer

Members of companies limited by guarantee are required to pay the amount they guaranteed if required when the company is wound up.

Attention!

Some of these requirements and terms will seem unfamiliar to you, but we will look at them in more detail in the following chapters.

The unlimited company certainly has its uses. It provides a **corporate body** (a separate legal entity) which can conveniently hold assets to which liabilities do not attach.

3.3 Public and private companies

FAST FORWARD

A company may be **private** or **public**. Only the latter may offer its share to the public.

Key term

A **public company** is a company whose constitution states that it is public and that it has complied with the registration procedures for such a company.

Key term

A **private company** is a company which has not been registered as a public company under the Companies Act. The major practical distinction between a private and public company is that the former may not offer its securities to the public.

In the UK a **public** company is a company registered as such under the Companies Act with the Registrar of Companies. **Any company not registered as public is a private company**.

A public company may be one which was **originally incorporated** as a public company or one which re-registered as a public company having been previously a private company.

3.4 Conditions for being a public company

FAST FORWARD

A **public company** must hold a Registrar's certificate that it has met the requirements, including **minimum capital** of **£50,000**.

3.4.1 Registrar's trading certificate

Before it can trade a company originally incorporated as a public company must have a trading certificate issued by the Registrar. The conditions for this are:

- The **name** of the company identifies it as a public company by ending with the words 'public limited company' or 'plc' or their Welsh equivalents, 'ccc', for a Welsh company.
- The **constitution** of the company states that 'the company is a public company' or words to that effect.
- The **allotted share capital** of the company is not less than the authorised minimum which is currently £50,000.
- It is a **company** limited by shares.

With regard to the minimum share capital of £50,000.

- A company originally incorporated as a public company will not be permitted to trade until its **allotted** share capital is at least £50,000.
- A private company which re-registers as a public company will not be permitted to trade until it has **allotted** share capital of at least £50,000; this needs only be paid up to one quarter of its nominal value (plus the whole of any premium).
- A private company which has share capital of £50,000 or more may of course continue as a private company; it is always **optional** to become a public company.

A company limited by guarantee which has no share capital, and an unlimited company, **cannot** be public companies.

3.4.2 Minimum membership and directors

A public company must have a minimum of **one member**. This is the same as a private company. However, unlike a private company it must have at least **two directors**. A private company must have just one. Directors do not usually have liability for the company's debts.

3.5 Private companies

A private company is the residual category and so does not need to satisfy any special conditions.

Private companies are generally small enterprises in which some if not all shareholders are also directors and *vice versa*. Ownership and management are combined in the same individuals. Therefore, it is unnecessary to impose on the directors complicated restrictions to safeguard the interests of members and so the number of rules that apply to public companies are reduced for private companies.

3.6 Differences between private and public companies

FAST FORWARD

The main differences between public and private companies relate to: **capital**, **dealings** in **shares**, **accounts**, **commencement of business**, **general meetings**, **names, identification**, and **disclosure requirements**.

The more important differences between public and private companies imposed by law relate to the following factors.

3.6.1 Capital

The main differences are:

(a) There is a minimum amount of **£50,000** for a **public** company, but **no minimum** for a **private** company.

(b) A public company may **raise capital** by **offering** its **shares** or debentures to the public; a **private** company is **prohibited** from doing so.

(c) Both **public** and **private companies** must generally **offer** to **existing members first** any ordinary shares to be allotted for cash. However a **private** company **may permanently disapply** this rule.

3.6.2 Dealings in shares

Only a **public company** can obtain a listing for its shares on the **Stock Exchange** or other investment exchange. To obtain the advantages of listing the company must agree to elaborate conditions contained in particulars in a **listing agreement** with The Stock Exchange. However, not all public companies are listed.

3.6.3 Accounts

(a) A **public** company has **six** months from the end of its accounting reference period in which to produce its statutory audited accounts. The period for a **private** company is **nine** months.

(b) A **private** company, if qualified by its size, may have **partial exemption** from various **accounting provisions** (discussed later in this text). These exemptions are not available to a public company or to its subsidiaries (even if they are private companies).

(c) A **listed public company** must publish its full accounts and reports on its **website**.

(d) Public companies must lay their **accounts** and reports before a general meeting annually. Private companies have no such requirement.

3.6.4 Commencement of business

A **private** company can commence business **as soon** as it is **incorporated**. A **public** company if incorporated as such must first **obtain a trading certificate from the Registrar**.

3.6.5 General meetings

Private companies are not required to hold annual general meetings, (AGMs). **Public companies** must hold one within six months of their financial year end.

3.6.6 Names and Identification

The rules on identification as public or private are as follows.

- The word **'limited'** or **'Ltd'** in the name denotes a private company; **'public limited company'** or **'plc'** must appear at the end of the name of a public company.
- The **constitution** of a **public** company must state that it is a public company. A **private company** should be identified as private.

3.6.7 Disclosure requirements

There are **special disclosure and publicity requirements** for public companies.

The main advantage of carrying on business through a public rather than a private company is that a public company, by the issue of listing particulars, may obtain a **listing** on The Stock Exchange and so mobilise capital from the investing public generally.

Attention!

There is an important distinction between public companies and **listed public companies**. Listed (or quoted) companies are those which trade their shares (and other securities) on stock exchanges. Not all public companies sell their shares on stock exchanges (although, in law, they are entitled to sell their shares to the public). **Private** companies are not entitled to sell shares to the public in this way.

In practice, only public companies meeting certain criteria would be allowed to obtain such a listing by the Stock Exchange.

Private companies may be broadly classified into two groups: independent (also called **free-standing)** private companies and **subsidiaries** of other companies.

4 Additional classifications

FAST FORWARD

There are a number of other ways in which companies can be **classified**.

4.1 Parent (holding) and subsidiary companies

The Companies Act draws a distinction between an 'accounting' definition, and a 'legal' definition in, s 1162. A company will be the **parent** (or **holding) company** of another company, its **subsidiary company**, according to the following rules.

Key term

Parent company

(a) It holds a **majority of the voting rights** in the subsidiary.

(b) It **is a member of the subsidiary and has the right to appoint or remove a majority of its board of directors**.

(c) **It has the right to exercise a dominant influence over the subsidiary**:

- (i) By virtue of provisions contained in the subsidiary's articles.
- (ii) By virtue of a control contract.

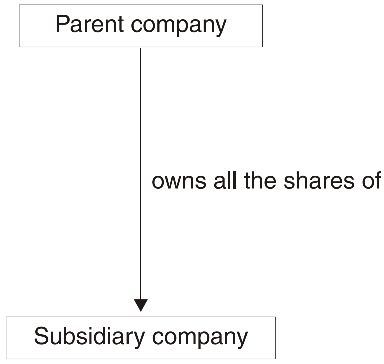
(d) **It is a member of the subsidiary and controls alone**, under an agreement with other members, **a majority of the voting rights in the company**.

(e) **A company is also a parent if**:

- (i) It has the power to exercise, or actually exercises, a dominant influence or control over the subsidiary
- (ii) It and the subsidiary are managed on a unified basis

(f) **A company is also treated as the parent of the subsidiaries of its subsidiaries**.

A company (A Ltd) is a **wholly owned subsidiary** of another company (B Ltd) if it has no other members except B Ltd and its wholly owned subsidiaries, or persons acting on B Ltd's or its subsidiaries' behalf.



The diagram illustrates a **simple group**. In practice, such groups might be much larger and much more complex.

The importance of the parent and subsidiary company relationship is recognised in company law in a number of rules.

(a) A parent company must generally prepare **group accounts** in which the financial situation of parent and subsidiary companies is consolidated as if they were one person.

(b) A subsidiary may **not ordinarily be a member** of its parent company.

(c) Since directors of a parent company can **control** its **subsidiary**; some rules designed to regulate the dealings of companies with directors also apply to its subsidiaries, particularly loans to directors.

4.2 Quoted companies

As we have seen public companies may seek a listing on a public exchange. This option is not open to private companies, who are not allowed to offer their shares for sale to the public. Listed companies are sometimes referred to as quoted companies (because their shares are quoted publicly).

4.3 Small companies regime

Small companies benefit from the small companies regime's reduced legal requirements in terms of filing accounts with the Registrar and obtaining an audit. The definitions of a small company for the purposes of accounting and auditing are almost identical.

In **accounting terms**, a company is small if it meets two of the following applicable criteria:

(a) Balance sheet total of not more than £3.26 million
(b) Turnover of not more than £6.5 million
(c) 50 employees or fewer on average

For **audit purposes**, a company is classed as small if it qualifies on the above criteria, but must **meet both** of conditions (a) and (b).

4.4 State-owned companies

FAST FORWARD

In some cases, companies might be owned by the **State**, in which case their operation is likely to be part of the State's planned economy.

We shall look at shares and membership in more detail in Chapter 12. As we have outlined, shares are often held by **individuals**, but they may also be held by institutions, such as other companies or pension funds, particularly if they are listed on stock exchanges.

In some cases, companies might be owned by the **state**.

4.4.1 Example: utility companies

A good example of this might be utility companies, such as gas, water and electricity companies. In many countries, these companies are owned by the State. In the UK, most such companies were **privatised** in the 1980s. This means they were sold to the public by the State and became ordinary listed companies.

State-owned companies are likely to be more common in countries with a **planned economy**.

Point to note

Look back to Chapter 1 if you can't remember what a planned economy is.

4.5 Multinational companies

FAST FORWARD

Multinational companies produce and sell in more than one country, and typically sell their shares in more than one country too.

The vast majority of companies will simply operate in one country. However, some of the larger companies in the world will operate in more than one country. Such companies are **multinational**.

Key term

A **multinational company** is a company that produces and markets its products in more than one country.

4.5.1 Examples: multinational companies

The top three multinational companies as voted by Fortune Global 500 at the end of 2007 were:

- Wal-mart stores
- Royal Dutch Shell
- Exxon Mobil

Such companies sell their shares on stock exchanges around the world.

Question — Small companies

State the criteria that a company must meet to be classified as small.

Answer

A small company must meet two of the following criteria:

- Its balance sheet total must not exceed £2.8 million.
- Turnover must be no more than £5.6 million.
- It must employ fewer than 50 employees.

5 Effect of legal personality

FAST FORWARD

Salomon v Salomon & Co Ltd 1897 was the first case (from England) which clearly demonstrated the **separate legal personality** of companies and is of great significance to any study of company law.

Salomon v Salomon & Co Ltd 1897

The facts: The claimant, S, had carried on business for 30 years. He decided to form a limited company to purchase the business. So he and six members of his family each subscribed for one share.

The company then purchased the business from S for £38,782, the purchase price being payable to the claimant by way of the issue of 20,000 £1 shares, £10,000 of debentures and £8,782 in cash.

The company did not prosper and was wound up a year later, at which point its liabilities exceeded its assets. The liquidator, representing unsecured trade creditors of the company, claimed that the company's business was in effect still the claimant's (he owned 20,001 of 20,007 shares). Therefore he should bear liability for its debts and that payment of the debenture debt to him should be postponed until the company's trade creditors were paid.

Decision: The House of Lords held that the business was owned by, and its debts were liabilities of, the company. The claimant was under no liability to the company or its creditors, his debentures were validly issued and the security created by them over the company's assets was effective. This is because the company was a legal entity separate and distinct from S.

The principle of separate legal personality was confirmed by more recent English cases.

Lee v Lee's Air Farming Ltd 1960

The facts: Mr Lee, who owned the majority of the shares of an aerial crop-spraying business, and was the sole working director of the company, was killed while piloting the aircraft.

Decision: Although he was the majority shareholder and sole working director of the company, he and the company were separate legal persons. Therefore he could also be an employee with rights against it when killed in an accident in the course of his employment.

5.1 Veil of incorporation

FAST FORWARD

Incorporation **'veils'** members from outsiders' view but this veil may be lifted in some circumstances, so creditors and others can seek redress directly from members. The veil may be lifted: by statute to enforce the law; to prevent the evasion of obligations and in certain situations where companies trade as a group.

Because a company has separate legal personality from the people who own or run it (the members/ shareholders/directors), people can look at a company and not know who or what owns or runs it.

The fact that members are 'hidden' in this way is sometimes referred to as the '**veil of incorporation**'. Literally, the members are 'veiled' from view.

6 Ignoring legal personality

FAST FORWARD

Separate personality can be ignored to:

- **Identify** the **company** with its **members** and/or directors.
- Treat a **group of companies** as a **single commercial entity** (if a company is owned by another company).

The more important of these two reasons is the first one, although the second reason can sometimes be more complex. The main instances for lifting the veil are given below.

6.1 Lifting the veil by statute to enforce the law

Lifting of the veil is permitted under a number of statutes to enforce the law.

6.1.1 Liability for trading without trading certificate

A public company must obtain a trading certificate from the Registrar before it may commence to trade. Failure to do so leads to **personal liability** of the directors for any loss or damage suffered by a third party resulting from a transaction made in contravention of trading certificate requirement. They are also liable for a fine.

6.1.2 Fraudulent and wrongful trading

When a company is wound up, it may appear that its business has been carried on with **intent** to **defraud creditors** or others. In this case the court may decide that the persons (usually the directors) who were knowingly parties to the **fraudulent trading** shall be **personally responsible** under civil law for debts and other liabilities of the company: s 213 Insolvency Act 1986.

Fraudulent trading is also a criminal offence; under s 993 of the Companies Act 2006 any person guilty of the offence, even if the company has not been or is not being wound up, is liable for a fine or imprisonment for up to 10 years.

If a company in insolvency proceedings is found to have traded when there is no reasonable prospect of avoiding insolvent liquidation, its directors may be liable under civil law for **wrongful trading**. Again a court may order such directors to make a contribution to the company's assets: s 214 Insolvency Act 1986.

6.1.3 Disqualified directors

Directors who participate in the management of a company in contravention of an order under the Company Directors Disqualification Act 1986 will be **jointly** or **severally liable** along with the company for the company's debts.

6.1.4 Abuse of company names

In the past there were a number of instances where directors of companies which went into **insolvent liquidation** formed another company with an identical or similar name. This new company bought the original company's business and assets from its liquidator.

The Insolvency Act 1986 (s 217) makes it a criminal offence and the directors personally liable where; they are a director of a company that goes into insolvent liquidation and; they become involved with the directing, managing or promoting of a business which has an **identical name** to the original company, or a **name similar** enough to suggest a connection.

Exam focus point

Questions in this area often require an explanation of separate personality and the circumstances where the veil of incorporation will be lifted – as in June 2008.

6.2 Lifting the veil to prevent evasion of obligations

A company may be identified with those who control it, for instance to determine its residence for tax purposes. The courts may also ignore the distinction between a company and its members and managers if the latter use that distinction to **evade** their **existing legal obligations**.

Gilford Motor Co Ltd v Home 1933

The facts: The defendant had been employed by the claimant company under a contract which forbade him to solicit its customers after leaving its service. After the termination of his employment he formed a company of which his wife and an employee were the sole directors and shareholders. However, he managed the company and through it evaded the covenant that prevented him from soliciting customers of his former employer.

Decision: An injunction requiring observance of the covenant would be made both against the defendant and the company which he had formed as a 'a mere cloak or sham'.

6.2.1 Public interest

In time of war a company is not permitted to trade with '**enemy aliens**'. The courts may draw aside the veil if, despite a company being registered in the UK, it is suspected that it is controlled by aliens.

The question of nationality may also arise in peacetime, where it is convenient for a foreign entity to have a British **facade** on its operations.

Re F G Films Ltd 1953

The facts: An English company was formed by an American company to 'make' a film which would obtain certain marketing and other advantages from being called a British film. Staff and finance were American and there were neither premises nor employees in England. The film itself was produced in India.

Decision: The British company was the American company's agent and so the film did not qualify as British. Effectively, the corporate entity of the British company was swept away and it was exposed as a 'sham' company.

6.2.2 Evasion of liabilities

The veil may also be lifted where directors **ignore** the separate legal personality of two companies and transfer assets from one to the other in disregard of their duties in order to avoid an existing liability.

Re H and Others 1996

The facts: The court was asked to rule that various companies within a group, together with the minority shareholders, should be treated as one entity in order to restrain assets prior to trial.

Decision: The order was granted. The court thought there was evidence that the companies had been used for the fraudulent evasion of excise duty.

6.2.3 Evasion of taxation

The court may lift the veil of incorporation where it is being used to **conceal** the nationality of the company.

Unit Construction Co Ltd v Bullock 1960

The facts: Three companies, wholly owned by a UK company, were registered in Kenya. Although the companies' constitutions required board meetings to be held in Kenya, all three were in fact managed entirely by the holding company.

Decision: The companies were resident in the UK and liable to UK tax. The Kenyan connection was a sham, the question being not where they ought to have been managed, but where they were actually managed.

6.2.4 Quasi-partnership

An application to wind up a company on the 'just and equitable' ground under the Insolvency Act 1986 may involve the court lifting the veil to reveal the company as a **quasi-partnership.** This may happen where the company only has a few members, all of whom are actively involved in its affairs. Typically the individuals have operated contentedly as a company for years but then fall out, and one or more of them seeks to remove the others.

The courts are willing in such cases to treat the central relationship between the directors as being that of partners, and rule that it would be unfair therefore to allow the company to continue with only some of its original members. This is illustrated by the case of *Ebrahimi v Westbourne Galleries Ltd 1973* which we will see in a later chapter.

Question — **Quasi-partnership**

Sandy and Pat have carried on business together for twenty years, most recently through a limited company in which each holds 500 shares. They share the profits equally in the form of directors' remuneration. Pat's son Craig joins the business, buying 100 shares from each of Sandy and Pat. Disputes arise and Pat and Craig use their voting majority to remove Sandy from the board. Advise Sandy.

Answer

Sandy cannot prevent her removal from her directorship. However, a court may find that, on the basis of the past relationship, it is unjust and inequitable to determine the case solely on legal rights and could, on equitable principles, order liquidation of the company.

The veil of the company may be lifted to reveal a quasi-partnership.

6.3 Lifting the veil in group situations

The principle of the veil of incorporation extends to the holding (parent) company/subsidiary relationship. Although holding companies and subsidiaries are part of a group under company law, they retain their **separate legal personalities**.

In *Adams v Cape Industries plc 1990*, three reasons were put forward for identifying the companies as one, and lifting the veil of incorporation. They are:

- The subsidiary is acting as **agent** for the holding company.
- The group is to be treated as a **single economic entity** because of statutory provision.
- The **corporate structure** is being used as a **facade** (or sham) to conceal the truth.

Adams v Cape Industries plc 1990

The facts: Cape, an English company, headed a group which included many wholly-owned subsidiaries. Some of these mined asbestos in South Africa, and others marketed the asbestos in various countries including the USA.

Several hundred claimants had been awarded damages by a Texas court for personal injuries suffered as a result of exposure to asbestos dust. The defendants in Texas included one of Cape's subsidiaries, NAAC. The courts also considered the position of AMC, another subsidiary, and CPC, a company linked to Cape Industries.

Decision: The judgement would not be enforced against the English holding company, either on the basis that Cape had been 'present' in the US through its local subsidiaries or because it had carried on business in the US through the agency of NAAC.

Slade LJ commented in giving the judgement that English law 'for better or worse recognises the creation of subsidiary companies ... which would fall to be treated as separate legal entities, with all the rights and liabilities which would normally be attached to separate legal entities'.

Whether desirable or not, English law allowed a group structure to be used so that legal liability fell on an individual member of a group rather than the group as a whole.

Exam focus point

Lifting the veil in group situations is easily forgotten. Ensure you know the *Cape Industries* case and the three reasons for lifting the veil in groups which it sets out.

6.4 Summary of situations in which the veil can be lifted

The instances in which the veil will be lifted are as follows.

Lifting the veil by statute to enforce the law	• Liability for trading without a trading certificate • Fraudulent and wrongful trading • Disqualified directors • Abuse of company names
Evasion of obligations	• Evasion of legal obligations • Public interest • Evasion of liabilities • Evasion of taxation • Quasi-partnership
Group situations	• Subsidiary acting as agent for the holding company • The group is to be treated as a single economic entity • The corporate structure is being used as a sham

6.5 Lifting the veil and limited liability

The above examples of lifting the veil include examples of where, if they have broken the law, **directors** can be made **personally liable** for a company's debts. This is very rare.

If those directors are also members then limited liability **does not apply**. This is the only time that limited liability is overridden and that the **member** becomes **personally liable** for the company's debts **due to their actions as a director.**

7 Other corporate forms

FAST FORWARD

Other national corporate forms comparable to the English form are:

- The **French SARL** and **SA**
- The **German GmbH** and **AG**

In Chapter 8, we looked at some business vehicles from other nations which are similar to the English partnership. Here we shall introduce some that are similar to the English company.

7.1 French sociétés

There are two further major types of société in France, which are loosely comparable to the English private and public companies:

- Société à responsabilité limitée (SARL)
- Société anonyme (SA)

A SARL gives members **limited liability**, similar to that conferred by membership of an English company. However, a **SARL does not have share capital**, so it is dissimilar to English companies in that respect.

Instead of share capital, the capital of the société is divided into parts which cannot be sold to the general public. SARLs are commonly used for **family companies**. They are comparable to private English companies (Ltd).

SAs are more like English **public companies (plcs)**. They must have more than six **shareholders** and between three and 12 **directors**. They must also have an **auditor**.

The constitution of an SA constitutes a **contract** between the shareholders. Many of the publicity and management requirements are similar to the English plc.

7.2 German Gesellschaften

The comparable corporate forms in Germany are:

- Gesellschaft mit beschränkter Haftung (GmbH)
- Aktiengesellschaft (AG)

The GmbH is very popular as a corporate form in Germany. There are approximately 150 times more GmbHs than AGs. It is used by medium-sized businesses and it is comparable to the English limited company.

AGs are comparable to the English plc.

7.3 Muslim companies

Although Muslim law provides for a large number of different types of partnership, as we saw in Chapter 8, there is **no corporate form as such in Muslim law**. Most Muslim countries would use a corporate form similar to English companies.

7.4 European companies

Businesses with operations in **more than one EU member state** can incorporate under a new EU-wide company form, the **European company** (**Societas Europaea**, SE). These are public companies with limited liability, and a minimum capital requirement of €120,000. They must be **registered** in the member state where the company has its administrative headquarters.

There are four ways of setting up a European company:

- A merger between existing companies from at least two member states
- Formation of a holding company by companies from at least two EU member states
- Formation of a subsidiary of companies from at least two member states
- Transformation of a company that has had a subsidiary in another EU member state for at least two years

The legal and tax provisions governing European companies are very complicated, reflecting the interaction of EU law and different national systems.

Chapter Roundup

- A company has a **legal personality** separate from its owners (known as members). It is a formal arrangement, surrounded by formality and publicity, but its chief advantage is that members' liability for the company's debts is typically limited.
- The fact that a **company's members** – not the company itself – have limited liability for its debts protects the members from the company's creditors and ultimately from the full risk of business failure.
- A company member's liability may be limited by **shares** or by **guarantee**, or it may be **unlimited**.
- A company may be **private** or **public**. Only the latter may offer its share to the public.
- A **public company** must hold a Registrar's certificate that it has met the requirements, including **minimum capital** of **£50,000**.
- The **main differences** between public and private companies relate to: directors; capital; dealings in shares, accounts; commencement of business; general meetings; names and identification; and interests in securities.
- There are a number of other ways in which companies can be **classified**.
- In some cases, companies might be owned by the **State**, in which case their operation is likely to be part of the State's planned economy.
- **Multinational companies** produce and sell in more than one country, and typically sell their shares in more than one country too.
- *Salomon v Salomon & Co Ltd 1897* was the first case (from England) which clearly demonstrated the **separate legal personality** of companies and is of great significance to any study of company law.
- Incorporation **'veils'** members from outsiders' view but this veil may be lifted in some circumstances, so creditors and others can seek redress directly from members. The veil may be lifted: by statute to enforce the law; to prevent the evasion of obligations and in certain situations where companies trade as a group.
- Separate personality can be ignored to:
  - **Identify** the **company** with its **members** and/or directors.
  - Treat a **group of companies** as a **single commercial entity** (if a company is owned by another company).
- Other national corporate forms comparable to the English form are:
  - The **French SARL** and **SA**
  - The **German GmbH** and **AG**

Quick Quiz

1 Which of the following types of company can be incorporated under the Companies Act 2006?

A A private limited company
B A public limited company
C A company limited by guarantee with a share capital
D A company limited by guarantee with no share capital
E A private unlimited company
F A public unlimited company

2 Which two of the following statements is true? A private company

A Is defined as any company that is not a public company

B Sells its shares on the junior stock market known as the Alternative Investment Market and on the Stock Exchange

C Must have at least one director with unlimited liability

D Is a significant form of business organisation in areas of the economy that do not require large amounts of capital

3 Under which circumstance would a member of a limited company have to contribute funds on winding up?

A Where there is not enough cash to pay the creditors

B Where they have an outstanding amount from when they originally purchased their shares

C To allow the company to repurchase debentures it issued

D Where the company is a community interest company and the funds are required to complete a community project

4 The minimum allotted and paid up share capital of a company incorporated as a public limited company is

A £12,500
B £50,000
C £100,000
D £500,000

5 **Fill in the blanks** in the statement below using the figures in the box.

A small company formed under the Companies Act 2006 must meet two of the following criteria.

Its balance sheet total must be less than £ … million and its turnover must be less than £ … million. The number of employees must be less than … people.

50	6.5
3.26	100

6 Which two of the following are correct? A public company or plc

A Is defined as any company which is not a private company
B Has a legal personality that is separate from its members or owners
C Must have at least one director with unlimited liability
D Can own property and make contracts in its own name

7 Put the examples given below in the correct category box.

WHEN THE VEIL OF INCORPORATION IS LIFTED		
To enforce law	**To enforce obligations**	**To expose groups**

- Wrong use of company name
- Legal obligations
- Quasi-partnership
- Disqualified directors
- Fraudulent and wrongful trading
- Single economic entity
- Corporate structure a sham
- Public interest

8 What is a SARL?

Answers to Quick Quiz

1 A, B, D and E are correct. It is not possible to incorporate a company limited by guarantee with a share capital, so C is incorrect. A public limited company is by definition limited, so F is wrong.

2 A and D are correct. A private company cannot sell its shares to the public on any stock market, so B is incorrect. Directors need not have unlimited liability, so C is incorrect.

3 B Members only have a liability for any outstanding amounts of share capital partly paid for.

4 B £50,000. Where the company was incorporated as a private one found subsequently re-registered on a public one, only a quarter of the authorised minimum must be paid up (£12,500).

5 Balance sheet total £3.26 million
Turnover £6.5 million
Employees less than 50

6 B and D are correct. A public company has to be defined as such in its constitution so A is incorrect. No directors *need* have unlimited liability, so C is incorrect.

7

WHEN THE VEIL OF INCORPORATION IS LIFTED		
To enforce law	**To enforce obligations**	**To expose groups**
Wrong use of company name Disqualified directors Fraudulent and wrongful trading	Legal obligations Quasi-partnership Public interest	Single economic entity Corporate structure a sham

8 A SARL is a société à responsabilité limitée, a type of French corporation, comparable to an English private company.

Now try the question below from the Exam Question Bank

Number	Level	Marks	Time
Q10	Examination	10	18 mins

10 Company formation

Topic list	Syllabus reference
1 Promoters and pre-incorporation contracts	D2(a)
2 Pre-incorporation expenses and contracts	D2(a)
3 Registration procedures	D2(b)
4 Statutory books and records	D2(c)
5 Statutory returns	D2(c)

Introduction

In Chapter 9 of this Study Text you were introduced to the idea of the separate legal personality of a company.

Sections 1 to 3 of this chapter concentrate on the **procedural aspects** of **company formation**. Important topics in these sections include the **formalities** that a company must observe in order to be formed, and the liability of **promoters for pre-incorporation contracts**.

Sections 4 and 5 of this chapter consider the concept of the **public accountability** of **limited companies**. Later on in your coverage of the syllabus you will meet references to a company's obligation to publicise certain decisions, so it is important to understand at this stage how and why this should be done.

Study guide

		Intellectual level
D	**The formation and constitution of joint stock companies**	
2	**The formation of the company**	
(a)	Explain the role and duties of company promoters	2
(b)	Describe the procedure for registering companies, both public and private	2
(c)	Describe the statutory books, records and returns that companies must keep or make	1

Exam guide

These topics can easily be examined in a knowledge question, but this does not preclude them from forming part of a scenario question. Questions could be set that require you to explain the procedures that need to be followed in order to set up a private or public limited company. You may need to advise a promoter on any potential liability they could encounter.

1 Promoters and pre-incorporation contracts

FAST FORWARD

A promoter **forms** a company. They must act with **reasonable skill** and **care**, and if shares are to be allotted they are the agent of the company, with an agent's fiduciary duties.

A company cannot form itself. The person who forms it is called a '**promoter**'. A promoter is an example of an **agent**.

Key term

A **promoter** is one who undertakes to form a company with reference to a given project and to set it going and who takes the necessary steps to accomplish that purpose: *Twycross v Grant 1877*.

In addition to the person who takes the procedural steps to get a company incorporated, the term 'promoter' includes anyone who makes **business preparations** for the company. **However**, a person who acts **merely** in a **professional capacity** in company formation, such as a solicitor or an accountant, **is not** on that account a **promoter**.

1.1 Duties of promoters

Promoters have the general duty to exercise **reasonable skill and care.**

If the promoter is to be the owner of the company there is no conflict of interest and it does not matter if the promoter obtains some advantage from this position, for example, by selling their existing business to the company for 100% of its shares.

If, however, **some or all the shares** of the company when formed **are to be allotted to other people**, the promoter is as **agent** of the company. This means they have the customary **duties** of an agent (see Chapter 7) and the following fiduciary duties.

(a) A promoter must account for any **benefits obtained** through acting as a promoter.

(b) Promoters must not put themselves in a position where their own **interests conflict** with those of the company.

(c) A promoter must provide **full information** on their transactions and account for all monies arising from them. The promoter must therefore make **proper disclosure** of any personal advantage to **existing** and **prospective** company **members** or to an **independent board of directors**.

A promoter may make a **profit** as a result of their position.

(a) A **legitimate** profit is made by a promoter who acquires interest in property **before promoting** a company and then makes a profit when they sell the property to the promoted company, provided they disclose it.

(b) A **wrongful** profit is made by a promoter who enters into and makes a profit personally in a contract as a promoter. They are in breach of fiduciary duty.

A promoter of a public company makes their disclosure of legitimate profit through listing particulars or a prospectus. If they make proper disclosure of a legitimate profit, they may retain it.

1.1.1 Remedy for breach of promoter's fiduciary duty

If the promoter does not make a proper disclosure of legitimate profits or if they make wrongful profits the primary remedy of the company is to **rescind** the **contract** and **recover its money**.

However, sometimes it is too late to rescind because the property can no longer be returned or the company prefers to keep it. In such a case the company can **only recover** from the promoter their **wrongful profit**, unless some special circumstances dictate otherwise.

Where shares are sold under a **prospectus offer**, promoters have a statutory liability to compensate any person who acquires securities to which the prospectus relates and suffered loss as a result of any untrue or misleading statement, or omission.

Statutory and listing regulations together with rigorous investigation by merchant banks have greatly lessened the problem of the dishonest promoter.

2 Pre-incorporation expenses and contracts

FAST FORWARD

A promoter has **no automatic right** to be reimbursed **pre-incorporation expenses** by the company, though this can be expressly agreed.

2.1 Pre-incorporation expenses

A promoter usually incurs **expenses** in preparations, such as drafting legal documents, made before the company is formed. They have **no automatic right to recover these 'pre-incorporation expenses'** from the company. However they can generally arrange that the first directors, of whom they may be one, **agree** that the company shall pay the bills or refund to them their expenditure. They could also include a special article in the company's constitution containing an indemnity for the promoter.

2.2 Pre-incorporation contracts

FAST FORWARD

Pre-incorporation contracts **cannot** be ratified by the company. A new contract on the same terms must be expressly created.

Key term

A **pre-incorporation contract** is a contract purported to be made by a company or its agent at a time before the company has been formed.

In agency law a principal may ratify a contract made by an agent retrospectively. However, a company can **never ratify** a contract made on its behalf **before it was incorporated**. It did not exist when the pre-incorporation contract was made; thus one of the conditions for ratification fails.

A company may enter into a **new contract** on **similar terms** after it has been incorporated (**novation**). However there must be **sufficient evidence** that the company has made a new contract. Mere recognition of the pre-incorporation contract by performing it or accepting benefits under it is not the same as making a new contract.

2.3 Liability of promoters for pre-incorporation contracts

The company's **agent** is **liable** on a contract to which they are deemed to be a party. The agent may also be entitled to enforce the contract against the other party and so they could transfer the right to **enforce** the contract to the company. Liability is determined by s 51(1) of the Companies Act 2006.

> 'A contract that purports to be made by or on behalf of a company at a time when the company has not been formed has effect, subject to any agreement to the contrary, as one made with the person purporting to act for the company or as agent for it, and he is personally liable on the contract accordingly.'

2.4 Other ways of avoiding liability as a promoter for pre-incorporation contracts

There are various other ways for promoters to avoid liability for a pre-incorporation contract.

(a) The contract remains as a **draft** (so not binding) until the company is formed. The promoters are the directors, and the company has the power to enter the contract. Once the company is formed, the directors take office and the company enters into the contract.

(b) If the contract has to be finalised before incorporation it should contain a clause that the personal liability of promoters is to cease if the company, when formed, enters a **new contract** on identical terms. This is known as **novation**.

(c) A common way to avoid the problem concerning pre-incorporation contracts is to buy a company **'off the shelf'** (see Section 3 of this chapter). Even if a person contracts on behalf of the new company before it is bought the company should be able to ratify the contract since it existed 'on the shelf' at the time the contract was made.

Exam focus point

A favourite question in law exams is the status of a pre-incorporation contract.

Question — Promoter

Fiona is the promoter of Enterprise Ltd. Before the company is incorporated, she enters into a contract purportedly on its behalf. After the certificate of incorporation is issued, the contract is breached. Who is liable?

Answer

Fiona is liable as promoters are liable for pre-incorporation contracts: s 51(1).

3 Registration procedures

FAST FORWARD

A company is **formed** and registered under the Companies Act 2006 when it is issued with a **certificate of incorporation** by the Registrar, after submission to the Registrar of a number of documents and a fee.

Most companies are registered under the Companies Act 2006.

A company is formed under the Companies Act 2006 by one or more persons subscribing to a memorandum of association who comply with the requirements regarding registration. A company may not be formed for an unlawful purpose.

3.1 Documents to be delivered to the Registrar

To obtain registration of a company limited by shares, an application for registration, various documents and a fee must be sent to the Registrar (usually electronically). We shall look at two of them (the articles and the memorandum of association) in detail, later in this Study Text.

3.1.1 Application for registration

S 9 requires an **application for registration** must be made and submitted to the Registrar with the other documents described in the table below.

The application must contain:

- The company's **proposed name**
- The **location** of its **registered office** (England and Wales, Wales, Scotland or Northern Ireland)
- That the **liability of members** is to be **limited** by **shares** or **guarantee**
- Whether the company is to be **private** or **public**.
- A statement of the **intended address** of the **registered office**.

Documents to be delivered	Description
Memorandum of association	This is a **prescribed form** signed by the subscribers. The memorandum states that the subscribers wish to form a company and they agree to become members of it. If the company has share capital each subscriber agrees to subscribe for at least one share.
Articles of association (only required if the company does not adopt model articles)	Articles are signed by the same subscriber(s), dated and witnessed. **Model articles** are provided by statute and can be adopted by a new company if: • No other articles are registered, or • If the articles supplied do not exclude or modify the model articles.
Statement of proposed officers	The statement gives the particulars of the proposed **director(s)** and **company secretary** if applicable. The persons named as directors must consent to act in this capacity. When the company is incorporated they are deemed to be appointed.
Statement of compliance	The statement that the **requirements** of the **Companies Act** in respect of registration have been **complied** with.
Statement of capital and initial shareholdings (only required for companies limited by shares)	A statement of capital and initial shareholdings must be delivered by all companies with **share capital**. (See Chapter 12 for the contents of this statement.) Alternatively, a statement of guarantee is required by companies limited by guarantee.
Registration fee	A registration fee (currently **£20)** is also payable on registration.

Exam focus point

Questions on incorporation could require you to identify the documents which should be sent to the Registrar.

3.2 Certificate of incorporation

The Registrar considers whether the documents are formally in order**.** If satisfied, the company is given a '**registered number**'. A **certificate of incorporation is** issued and notice of it is publicised.

A company is registered by the inclusion of the company in the register, and the issue of a **certificate of incorporation** by the Registrar. The certificate:

- Identifies the company by its **name** and **registered number**
- States that it is **limited** (if appropriate) and whether it is a **private** or **public** company
- States whether the **registered office** is in England and Wales, Wales, Scotland or Northern Ireland
- States the date of incorporation
- Is **signed** by the **Registrar**, or authenticated by the Registrar's official seal.

Key term

> The **certificate of incorporation** is a certificate issued by the Registrar which denotes that, from the date of incorporation, the subscribers, together with any persons who from time to time become members, become a body corporate 'capable of exercising all the functions of an incorporated company'.

The certificate of incorporation is conclusive evidence that:

- All the **requirements** of the **Companies Act** have been **followed.**
- The company is a company authorised to be registered and has been duly registered.
- If the certificate states that the company is a **public company** it is conclusive.

If irregularities in formation procedure or an error in the certificate itself are later discovered, the certificate is nonetheless **valid** and **conclusive:** *Jubilee Cotton Mills Ltd v Lewes 1924*.

Upon incorporation persons named as **directors** and **secretary** in the statement of proposed officers automatically become such officers.

3.2.1 Example: registering a French société anonyme (SA)

A series of formalities must be completed to form a société anonyme (SA) in France. The participants (future shareholders) must make a declaration that they are forming a SA before a notary. The shareholders (of whom there must be more than **seven**) must hold a general meeting. At the meeting, they must appoint between three and 12 directors (administrateurs) and at least two auditors (commissaries aux comptes). They must then ensure that the company is entered on the Commercial Register.

3.3 Companies 'off the shelf'

FAST FORWARD

> Buying a company '**off the shelf**' avoids the administrative burden of registering a company.

Because the registration of a new company can be a lengthy business, it is often easiest for people wishing to operate as a company to purchase an **'off the shelf' company**. This is possible by contacting enterprises specialising in registering a stock of companies, ready for sale when a person comes along who needs the advantages of incorporation.

Normally the persons associated with the company formation enterprise are registered as the company's subscribers, and its first secretary and director. When the company is purchased, the **shares** are **transferred** to the **buyer**, and the Registrar is notified of the director's and the secretary's resignation.

The principal **advantages** for the purchaser of purchasing an off the shelf company are as follows.

(a) The **following documents** will **not need** to be **filed** with the Registrar by the purchaser:

  (i) Memorandum and articles (unless the articles are not model articles)
  (ii) Application for registration
  (iii) Statement of proposed officers
  (iv) Statement of compliance
  (v) Statement of capital and initial shareholdings
  (vi) Fee

  This is because the specialist has already registered the company. It will therefore be a quicker, and very possibly cheaper, way of incorporating a business.

(b) There will be **no risk** of **potential liability** arising from pre-incorporation contracts. The company can trade without needing to worry about waiting for the Registrar's certificate of incorporation.

The **disadvantages** relate to the changes that will be required to the off-the-shelf company to make it compatible with the members' needs.

(a) The off-the-shelf company is likely to have **model articles**. The directors may wish to amend these.
(b) The directors may want to **change** the **name** of the company.
(c) The **subscriber shares** will need to be **transferred**, and the transfer recorded in the register of members. Stamp duty will be payable.

BPP LEARNING MEDIA

Question

Documents required on formation of a company

What are the documents which must be delivered to the Registrar for registration of a company?

Answer

The memorandum of association (and articles if not in model form), application for registration, a statement of proposed officers, a statement of compliance, a statement of capital and initial shareholdings, and a fee.

3.4 Re-registration procedures

FAST FORWARD

A **private company** with share capital may be able to re-register as a **public company** if the share capital requirement is met. A public company may re-register as a private one.

Note. For a private company to re-register as a public company it must fulfil the share capital requirement of a public company: Its allotted share capital must be at least £50,000 of which a quarter must be paid up, plus the whole of any premium.

	Re-registering as a public company	Re-registering as a private company
Resolution	The **shareholders must agree** to the company going public • Convene a general meeting • Pass a **special resolution** (75% majority) – Alters the constitution	The **shareholders must agree** to the company going private • Convene a general meeting • Pass a **special resolution** (75% majority of those present and voting) – Alters the constitution
Application	The **company must** then **apply** to the Registrar to go public • Send application to the Registrar • Send additional information to the Registrar, comprising – Copy of the special resolution – Copy of proposed new public company articles – Statement of the company's proposed name on re-registration – Statement of proposed company secretary – Balance sheet and related auditors' statement which states that at the balance sheet date the company's net assets are not less than its called-up share capital and undistributable reserves. – Statement of compliance – Valuation report regarding allotment of shares for non-cash consideration since the balance sheet date	The **company must** then **apply** to the Registrar to go private • Send the application to the Registrar • Send additional information to the Registrar, comprising – Copy of the special resolution – Copy of altered new private company articles – Statement of Compliance – Statement of the company's proposed name on re-registration

	Re-registering as a public company	Re-registering as a private company
Approval	The Registrar must accept the statement of compliance as sufficient evidence that the company is entitled to be re-registered as public. A certificate of incorporation on re-registration is issued.	The Registrar issues a certificate of incorporation on re-registration.
Compulsory re-registration	If the **share capital** of a public company **falls below £50,000**, it must re-register as a private company.	There is **no such compulsion** for a private company.

3.5 Commencement of business rules

FAST FORWARD

To **trade** or **borrow**, a public company needs a **trading certificate**. Private companies may commence business on **registration**.

3.5.1 Public companies

A **public company** incorporated as such may not do business or exercise any borrowing powers unless it has obtained a **trading certificate** from the Registrar: s761. This is obtained by sending an application to the Registrar. A private company which is re-registered as a public company is not subject to this rule.

The application:

- States the nominal value of the allotted share capital is not less than £50,000 or prescribed Euro equivalent (s 763)
- States the particulars of preliminary expenses and payments or benefits to promoters
- Must be accompanied by a statement of compliance.

If a public company does business or borrows before obtaining a certificate the other party is protected since the **transaction is valid**. However the company and any officer in default have committed an offence **punishable** by a **fine**. They may also have to indemnify the third party.

Under s 122 of the Insolvency Act 1986 a court may **wind-up** a public company which does not obtain a trading certificate within **one year** of incorporation.

3.5.2 Private company

A **private company** may do business and exercise its borrowing powers from the date of its incorporation. After registration the following procedures are important.

(a) A **first meeting** of the directors should be held at which the chairman, secretary and sometimes the auditors are appointed, shares are allotted to raise capital, authority is given to open a bank account and other commercial arrangements are made.

(b) A **return of allotments** should be made to the Registrar.

(c) The company may give notice to the Registrar of the **accounting reference date** on which its annual accounts will be made up. If no such notice is given within the prescribed period, companies are deemed to have an accounting reference date of the **last day of the month** in which the **anniversary of incorporation** falls.

4 Statutory books and records

4.1 The requirement for public accountability

FAST FORWARD

The price of limited liability is greater **public accountability** via the Companies Registry, registers, the *London Gazette* and company letterheads.

Under company law the privileges of trading through a separate corporate body are matched by the duty to provide information which is available to the public about the company.

Basic sources of information on UK companies
The Registrar keeps a file at **Companies House** which holds all documents delivered by the company for filing. Any member of the public, for example someone who intends to do business with the company, may inspect the file (usually electronically).
The **registers and other documents** which the company is required to hold at its registered office (or in some cases at a different address). These are looked at later in this chapter.
The *London Gazette*, a specialist publication, in which the company itself or the Registrar is required to publish certain notices or publicise the receipt of certain documents.
The **company's letterheads** and other forms which must give particulars of the company's place of registration, its identifying number and the address of its office.

4.2 The Registrar of Companies

The Registrar of Companies (the Registrar) and the Registrar's department within the Government is usually called Companies House (in full it is 'the Companies Registration Office').

For **English** and **Welsh** companies the Registrar is located at the Companies House in **Cardiff**; for **Scottish** companies the Registrar is in **Edinburgh**.

The company is identified by its **name** and **serial number** which must be stated on every document sent to Companies House for filing.

On first incorporation the company's file includes a copy of its **certificate of incorporation** and the **original documents** presented to secure its incorporation.

Once a company has been in existence for some time the file is likely to include the following.

- Certificate of incorporation
- Public company trading certificate
- Each year's annual accounts and return
- Copies of special and some ordinary resolutions
- A copy of the altered articles of association if relevant
- Notices of various events such as a change of directors or secretary
- If a company issues a prospectus, a signed copy with all annexed documents

4.3 Statutory books

FAST FORWARD

A company must keep **registers** of certain aspects of its constitution, including the registers of members, charges and directors.

Various people are entitled to have access to **registers** and copies of records that the company must keep, so the company must keep them at its registered office or another location permitted by the secretary of state if the Registrar is notified.

Register/copies of records	Relevant CA2006 section
Register of **members**	s 113
Register of **charges**	s 876
Records of **directors (and secretaries)**	s 162 and s 275
Records of **directors' service contracts and indemnities**	s 228 and s 237
Records of **resolutions and meetings** of the company	s 355
Register of **debentureholders**	s 743
Register of disclosed **interests** in shares (public company ONLY)	s 808

Attention!

We will learn more about the **registered office** in Chapter 11. Some of the registers below contain details of shares and classes of shares. We will learn more about types of share in Chapter 12. Similarly, others refer to charges, directors and debentures. We shall learn about all of these later. For now you must just learn the content of each register.

4.4 Register of members

Every company must keep a register of members. It must contain:

(a) The name and address of each member

(b) **The shareholder class** (if more than one) to which they belong unless this is indicated in the particulars of their shareholding

(c) If the company has a share capital, the **number of shares** held by each member. In addition:

  (i) If the shares have **distinguishing numbers**, the member's shares must be identified in the register by those numbers

  (ii) If the company has more than one class of share the member's shares must be **distinguished** by their **class**, such as preference, ordinary or non-voting shares.

(d) The date on which each member **became** and eventually the date on which they **ceased** to be a member

The company may choose where it keeps the register of members available for inspection from:

- The registered office
- Another office of the company
- The office of a professional registrar

Any member of the company can inspect the register of members of a company without charge. A member of the public must pay but has the right of inspection.

A company with more than 50 members must keep a separate index of those members, unless the register itself functions as an index.

4.5 Register of charges

The register of charges must contain:

- **Details of fixed or floating charges** affecting the company property or undertaking
- **Brief descriptions** of property charged
- The **amount** of the charge
- The **name** of the person entitled to the charge

A company must also keep copies of every instrument creating a charge at its registered office or some other designated place notified to the Registrar. Any person may inspect the instruments and the charges register; members and creditors may inspect free of charge.

4.6 Register of directors

The register of directors must contain the following details in respect of a director who is an individual (that is, not a company).

- **Present** and **former** forenames and surnames
- A **service address** (may be the company's registered address rather than the director's home address)
- **Residency** and **nationality**
- **Business occupation** (if any)
- **Date of birth**

The register does not include shadow directors (discussed in a later chapter). It must be open to inspection by a member (free of charge), or by any other person (for a fee).

Note the company must keep a separate **register** of **directors' residential addresses** but this is not available to members or the general public.

4.6.1 Corporate directors

Where a legal person (such as a company) is a director, the register of directors must contain:

- The corporate or firm name
- Its registered or principal office

4.7 Records of directors' service contracts

The company should keep **copies** or written memoranda of all **service contracts** for its directors, including contracts for services which are not performed in the capacity of director. Members are entitled to view these copies for free, or request a copy on payment of a set fee.

Key term

Under s 227 a **director's service contract**, means a contract under which:

(a) A director of the company undertakes personally to perform services (as director or otherwise) for a company, or for a subsidiary of the company, or

(b) Services (as director or otherwise) that a director of the company undertakes personally to perform are made available by a third party to the company, or to a subsidiary of the company.

4.8 Register of debentureholders

Companies with debentures issued nearly always keep a **register of debentureholders**, but there is no statutory compulsion to do so. If a register of debentureholders is maintained, it should be held at the **registered office** or another location permitted by the Secretary of State and notified to the Registrar.

4.9 Accounting records

FAST FORWARD

Companies must keep **sufficient accounting records** to explain the company's transactions and its financial position, in other words so a profit and loss account and balance sheet can be prepared.

A company is required to keep accounting records sufficient to **show and explain** the company's transactions. At any time, it should be possible:

- To **disclose** with reasonable accuracy the **company's financial position** at intervals of not more than six months
- For the directors to ensure that any accounts required to be prepared **comply** with the **Act** and **International Accounting Standards**

Certain specific records are required by the Act.

(a) Daily entries of **sums paid** and **received**, with details of the source and nature of the transactions

(b) A record of assets and liabilities

(c) **Statements of stock** held by the company at the end of each financial year

(d) **Statements of stocktaking** to back up the records in (c)

(e) **Statements of goods bought and sold** (except retail sales), together with details of buyers and sellers sufficient to identify them

The requirements (c) to (e) above apply only to businesses involved in dealing in goods.

Accounting records must be kept for **three** years (in the case of a **private** company), and **six** years in that of a **public** one.

Accounting records should be kept at the company's **registered office** or at some other place thought fit by the directors. Accounting records should be open to **inspection** by the **company's officers**. Shareholders have **no statutory rights** to inspect the records, although they may be granted the right by the articles.

Failure in respect of these duties is an offence by the officers in default.

4.10 Annual accounts

FAST FORWARD

A registered company must prepare **annual accounts** showing a true and fair view, lay them and various reports before members, and file them with the Registrar following directors' approval.

For each **accounting reference period** (usually 12 months) of the company the directors must prepare accounts. Where they are prepared in Companies Act format they must include a **balance sheet** and **profit and loss account** which give a **true and fair view** of the individual company's and the group's:

- Assets
- Liabilities
- Financial position
- Profit or loss

The accounts can either be in **Companies Act format** or prepared in accordance with **International Accounting Standards (IAS)**. Where International Accounting Standards are followed a note to this effect must be included in the notes to the accounts.

Most private companies are permitted to file abbreviated accounts.

The company's board of directors must **approve** the **annual accounts** and they must be signed by a director on behalf of the board. When directors approve annual accounts that do not comply with the Act or IAS they are **guilty** of an **offence**.

A public company is required to **lay its accounts**, and the **directors' report**, before **members** in **general meeting**. A quoted company must also lay the directors' remuneration report before the general meeting.

A company must file its annual accounts and its report with the **Registrar** within a maximum period reckoned from the date to which the accounts are made up. The standard permitted interval between the end of the accounting period and the filing of accounts is **six months** for a **public** and **nine months** for a **private company**.

The accounts must be **audited** (if the company exceeds any of the three Companies Act criteria already mentioned). The **auditors' report** must be attached to the copies issued to members, filed with the Registrar or published. Exemptions apply to **small and dormant companies**, though members may require an audit.

The accounts must also be accompanied by a **directors' report** giving information on a number of prescribed matters. These include (where an audit was necessary) a statement that there is no relevant information of which the auditors are unaware, and another statement from the directors that they exercised due skill and care in the period. Quoted companies must submit the **directors' remuneration report**.

Each **member** and **debentureholder** is entitled to be sent a copy of the **annual accounts**, together with the directors' and auditor's reports. In the case of public companies, they should be sent at least 21 days before the meeting at which they shall be laid. In the case of private companies they should be sent at the same time as the document are filed, if not earlier.

Anyone else entitled to **receive** notice of a general meeting, including the company's auditor, should **also be sent** a copy. At any other time any member or debentureholder is entitled to a copy free of charge within **seven days** of requesting it.

All companies may prepare a summary financial statement to be circulated to members instead of the full accounts, subject to various requirements as to form and content being met. However, members have the right to receive full accounts should they wish to.

Quoted companies must make their annual accounts and reports available on a website which is maintained on the company's behalf and which identifies it. The documents must be made available as soon as reasonably practicable and access should not be conditional on the payment of a fee or subject to other restrictions.

Where the company or its directors **fail to comply** with the requirements of the Act, they may be subject to a **fine**.

5 Statutory returns

FAST FORWARD

Every company must make an **annual return** to the Registrar.

Every company must make an annual return each year to the Registrar which is made up to a 'return date'. This date is either the **anniversary of incorporation** or the **anniversary of the date** of the previous return (if this differs). The return must be delivered to the Registrar within **28 days** of the return date.

The **return** must be **signed** by a director or a secretary, and **accompanied** by a fee of £30 or £15 if sent electronically.

The form of the annual return prescribed for a company which has share capital is:

- The address of the **registered office** of the company
- The address (if different) at which the **register of members** or **debentureholders** is kept
- The type of company and its principal **business activities**
- The total number of **issued shares,** their **aggregate nominal value** and the amounts paid and unpaid on each share
- For each **class of shares**, the **right** of those shares, the **total number** of shares in that class and their **total nominal value**
- Particulars of **members** of the company
- Particulars of those who have **ceased** to be members since the last return
- The number of shares of each **class** held by members at the return date, and transferred by members since incorporation or the last return date
- The particulars of directors, and secretary (if applicable)

Question

Records and returns

Which of the following must be filed with the Registrar each year?

1 Accounts
2 Register of members
3 Copies of directors' service contracts
4 The annual return

Answer

Only the accounts and annual return would be filed. The register of members and copies of directors' service contracts are held by the company and are not required by the Registrar.

Chapter Roundup

- A promoter **forms** a company. They must act with **reasonable skill** and **care**, and if shares are allotted they are the agent of the company, with an agent's fiduciary duties.
- A promoter has **no automatic right** to be reimbursed pre-incorporation expenses by the company, though this can be expressly agreed.
- Pre-incorporation contracts **cannot** be ratified by the company. A new contract on the same terms must be expressly created.
- A company is **formed and registered** under the Companies Act 2006 when it is issued with a **certificate of incorporation** by the Registrar, after submission to the Registrar of a number of documents and a fee.
- Buying a company **'off the shelf'** avoids the administrative burden of registering a company.
- A **private company** with share capital may be able to re-register as a **public company** if the share capital requirement is met. A public company may re-register as a private one.
- To **trade** or **borrow**, a public company needs a **trading certificate**. Private companies may commence business on **registration**.
- The price of limited liability is greater **public accountability** is via the Companies Registry, registers, the *London Gazette* and company letterheads.
- A company must keep **registers** of certain aspects of its constitution, including the registers of members, charges and directors.
- Companies must keep **sufficient accounting records** to explain the company's transactions and its financial position, in other words so a profit and loss account and balance sheet can be prepared.
- A registered company must prepare **annual accounts** showing a true and fair view, lay them and various reports before members, and file them with the Registrar following directors' approval.
- Every company must make an **annual return** to the Registrar.

Quick Quiz

1 A company can confirm a pre-incorporation contract by performing it or obtaining benefits from it.

True ☐

False ☐

2 If a public company does business or borrows before obtaining a trading certificate from the Registrar, the transaction is:

A Invalid, and the third party cannot recover any loss
B Invalid, but the third party may recover any loss from the directors
C Valid, and the directors are punishable by a fine
D Valid, but the third party can sue the directors for further damages

3 A company must keep a register of directors. What details must be revealed?

A Full name
B Service address
C Nationality
D Date of birth
E Business occupation

4 An accountant or solicitor acting in their professional capacity during the registration of a company may be deemed a promoter.

True ☐

False ☐

5 If a certificate of incorporation is dated 6 March, but is not signed and issued until 8 March, when is the company deemed to have come into existence?

Answers to Quick Quiz

1 False. The company must make a new contract on similar terms

2 C. The directors are punished for allowing the company to trade before it is allowed to.

3 All of them

4 False. A person acting in a professional capacity will not be deemed a promoter.

5 6 March. The date on the certificate is conclusive.

Now try the question below from the Exam Question Bank

Number	Level	Marks	Time
Q11	Examination	10	18 mins

11

Constitution of a company

Topic list	Syllabus reference
1 Memorandum of association	D3(a)
2 A company's constitution	D3(a), D3(c)
3 Company objects and capacity	D3(b)
4 The constitution as a contract	D3(b)
5 Company name and registered office	D3(d)

Introduction

In the previous chapter the **articles of association** was mentioned briefly as one of the documents that may be required to be submitted to the Registrar when applying for registration. The articles, together with any resolutions and agreements which may affect them, form the company's **constitution**.

The constitution sets out what the company does; if there are no restrictions specified then the company may do anything provided it is legal. Clearly this includes the capacity to contract, an important aspect of legal personality. Also significant is the concept of **ultra vires**, a term used to describe transactions that are outside the scope of the company's capacity.

Study guide

		Intellectual level
D	**The formation and constitution of joint stock companies**	
3	**The constitution of the company**	
(a)	Describe the contents of model articles of association	1
(b)	Analyse the effect of a company's constitutional documents	2
(c)	Explain how articles of association can be changed	2
(d)	Explain the controls over the names that companies may or may not use	2

Exam guide

A company's constitution could easily be examined in either a knowledge or an application question. You may be asked to explain any of the constitutional documents and how they may be altered.

1 Memorandum of association

FAST FORWARD

The memorandum is a **simple document** which states that the subscribers wish to form a company and become members of it.

Before the Companies Act 2006, the **memorandum of association** was an extremely important document containing information concerning the relationship between the company and the outside world – for example its aims and purpose (its objects).

The position changed with the 2006 Act and much of the information contained in the old memorandum is now to be found in the Articles of Association, which we will come to shortly. The **essence** of the memorandum has been retained, although it is now a very simple historical document which states that the **subscribers** (the initial shareholders):

(a) Wish to **form a company** under the Act, and

(b) Agree to **become members** of the company and, to take at least one share each if the company is to have share capital.

The memorandum must be in the **prescribed form** and must be **signed** by each subscriber.

It has been deemed by the Companies Act 2006 that companies which were incorporated under a **previous** Act and whose memorandum contains provisions now found in the articles, shall have these provisions interpreted as if they are part of the articles.

2 A company's constitution

FAST FORWARD

A **company's constitution** comprises the **Articles of Association** and any **resolutions and agreements** it makes which affect the constitution.

According to s 17 of the Companies Act 2006, the constitution of a company consists of:

- The Articles of Association
- **Resolutions and agreements** that it makes that affects the constitution

We shall consider resolutions and agreements first as an understanding of what they are is required to understand how the Articles of Association are amended.

2.1 Resolutions and agreements

In addition to the main **constitutional document** (the Articles of Association), **resolutions** and **agreements** also form part of a company's constitution. Resolutions are covered in Chapter 16 of this Study Text so you may find it beneficial to study Section 3 of that chapter now so that you understand the various types of resolution that a company may pass.

Resolutions directly affect the constitution of a company as they are used to **introduce** new provisions, or to **amend** or **remove** existing ones. **Agreements** made, for example between the company and members of specific classes of share (see Chapter 12) are also deemed as amending the constitution.

Copies of resolutions or agreements that amend the constitution must be sent to the Registrar within **15 days** of being passed or agreed. If a company fails to do this then every officer who is in default commits an offence punishable by fine. Where a **resolution** or **agreement** which affects a company's constitution is **not in writing**, the company is required to send the registrar a **written memorandum** that sets out the terms of the resolution or agreement in question.

2.2 Articles of Association

Key term

The **articles of association** consist of the internal rules that relate to the management and administration of the company.

The articles contain the detailed **rules** and **regulations** setting out how the company is to be **managed** and **administered**. The Act states that the registered articles should be contained in a **single document** which is divided into **consecutively numbered paragraphs**. Articles should contain rules on a number of areas, the most important being summarised in the table below.

CONTENTS OF ARTICLES	
Appointment and dismissal of directors	Communication with members
Powers, responsibilities and liabilities of directors	Class meetings
Directors' meetings	Issue of shares
General meetings; calling, conduct and voting	Transfer of shares
Members' rights	Documents and records
Dividends	Company secretary

2.2.1 Model articles

Rather than each company having to draft their own articles, and to allow companies to be set up **quickly** and **easily**, the Act allows the Secretary of State to provide **model** (or standard) **articles** that companies can adopt. Different models are available for different types of company; most companies would adopt model **private** or **public company** articles.

Companies are free to use **any** of the model articles that they wish by registering them on incorporation. If **no articles** are registered then the company will be **automatically incorporated** with the **default model articles** which are relevant to the type of company being formed. Model articles can be **amended** by the members and therefore tailored to the specific needs of the company.

Model articles are effectively a **'safety net'** which allow directors and members to take decisions if the company has failed to include suitable provisions in its registered articles or registered no articles at all.

The following summarises the model articles for a private limited company as provided by the **Department for Business, Enterprise and Regulatory Reform** (BERR). Do not try to learn the contents but use it to understand the type of information contained in them. We shall cover a number of the draft articles later in this Study Text.

Model articles for private companies limited by shares

Index to the articles

Part 1 Definitions and interpretation

1. Defined terms

Part 2 Directors

Directors' powers and responsibilities

2. Directors' general authority
3. Shareholders' reserve power
4. Directors may delegate
5. Committees

Decision-making by directors

6. Directors to take decisions collectively
7. Unanimous decisions
8. Majority decisions without directors' meeting
9. Calling a directors' meeting
10. Participation in directors' meetings
11. Quorum for majority decisions
12. Chairing of majority decision-making processes
13. Casting vote
14. Conflicts of interest
15. Records of decisions to be kept
16. Directors' discretion to make further rules

Appointment of directors

17. Methods of appointing directors
18. Termination of director's appointment
19. Directors' remuneration
20. Directors' expenses

Part 3 Shares and distributions

Shares

21. All shares to be fully paid up
22. Powers to issue different classes of share
23. Company not bound by less than absolute interests
24. Share certificates
25. Replacement share certificates
26. Share transfers
27. Transmission of shares
28. Exercise of transmittees' rights
29. Transmittees bound by prior notices

Dividends and other distributions

30. Procedure for declaring dividends
31. Payment of dividends and other distributions
32. No interest on distributions
33. Unclaimed distributions
34. Non-cash distributions
35. Waiver of distributions

Capitalisation of profits

36. Authority to capitalise and appropriation of capitalised sums

Part 4 Decision-making by shareholders

Organisation of general meetings

37. Attendance and speaking at general meetings
38. Quorum for general meetings
39. Chairing of general meetings
40. Attendance and speaking by directors and non-shareholders
41. Adjournment

Voting at general meetings

42. Voting: general
43. Errors and disputes
44. Poll votes
45. Content of proxy notices
46. Delivery of proxy notices
47. Amendments to resolutions

Part 5 Administrative arrangements

48. Means of communication to be used
49. Addresses and other contact details
50. Company seals
51. No right to inspect accounts and other records
52. Provision for employees on cessation of business

Directors' indemnity and insurance

53. Indemnity
54. Insurance

2.2.2 Alteration of the articles

FAST FORWARD

The articles may be altered by a **special resolution**. The basic test is whether the alteration is for the **benefit of the company as a whole**.

Any company has a statutory power to alter its articles by **special resolution:** s 21. A private company may pass a **written resolution** with a **75% majority.** The alteration will be valid and binding on **all** members of the company. **Copies** of the amended articles must be sent to the **Registrar**, within 15 days of the amendment, taking effect.

2.2.3 Making the company's constitution unalterable

There are devices by which some provisions of the company's constitution can be made **unalterable** unless the member who wishes to prevent any alteration consents.

(a) The articles may give to a member **additional votes** so that he can block a resolution to alter articles on particular points (including the removal of his weighted voting rights from the articles): *Bushell v Faith 1970.* However, to be effective, the articles must also limit the powers of members to alter the articles that give extra votes.

(b) The articles may provide that when a meeting is held to vote on a proposed alteration of the articles the **quorum present must include** the **member concerned**. They can then deny the meeting a quorum by absenting themselves (see Chapter 16).

(c) Section 22 of the Act permits companies to **'entrench' provisions** in its articles. This means specific provisions may only be **amended** or **removed** if certain **conditions** are met which are more restrictive than a special resolution such as agreement of all the members. However, such 'entrenched provisions' **cannot** be drafted so that the articles can never be amended or removed.

2.2.4 Restrictions on alteration

Even when it is possible to hold a meeting and pass a special resolution, alteration of the articles is **restricted** by the following principles.

(a) The alteration is **void** if it **conflicts with the Companies Act** or with general law.

(b) In various circumstances, such as to protect a minority (s 994), the **court may order** that an alteration be made or, alternatively, that an existing article shall not be altered.

(c) An existing **member may not be compelled** by alteration of the articles to **subscribe for additional shares** or to accept increased liability for the shares which they hold unless they have given their consent: s 25.

(d) An alteration of the articles which varies the rights attached to a class of shares may only be made if the **correct rights variation procedure** has been followed to obtain the consent of the class: s 630. A 15 per cent minority may apply to the court to cancel the variation under s 633.

(e) A person whose **contract** is contained in the articles cannot obtain an injunction to prevent the articles being altered, **but** they may be entitled to **damages** for breach of contract: see *Southern Foundries (1926) Ltd v Shirlaw 1940* in Chapter 15. Alteration cannot take away rights already acquired by performing the contract.

(f) An alteration may be void if the majority who approve it are not acting *bona fide* in what they deem to be the interests of the company as a whole (see below).

The case law on the **bona fide test** is an effort to hold the balance between two principles:

(a) The **majority** is **entitled** to **alter articles** even though a minority considers that the alteration is prejudicial to its interests.

(b) A minority is entitled to protection against an alteration which is intended to **benefit** the **majority** rather than the company and which is **unjustified discrimination** against the minority.

Principle (b) tends to be **restricted** to cases where the majority seeks to expel the minority from the company. The most elaborate analysis of this subject was made by the Court of Appeal in the case of *Greenhalgh v Arderne Cinemas Ltd 1950*. Two main propositions were laid down by Evershed MR.

(a) **'Bona fide for the benefit of the company as a whole'** is a **single test** and also a **subjective test** (what did the majority believe?). The court will not substitute its own view.

(b) 'The company as a whole' means, in this context, **the general body of shareholders.** The test is whether every 'individual hypothetical member' would in the honest opinion of the majority benefit from the alteration.

If the purpose is to benefit the company as a whole the alteration is valid even though it can be shown that the minority does in fact suffer special detriment and that other members escape loss. In *Allen v Gold Reefs of West Africa Ltd 1900* the articles were altered to extend the company's lien from just partly paid shares to all shares. In fact only one member held fully paid shares. The court overruled his objections on the grounds that:

(a) The alteration was for the benefit of the company as a whole and applied to any member who held fully paid shares.

(b) The members held their shares subject to the constitution, and hence were subject to any changes to those documents.

2.2.5 Expulsion of minorities

Expulsion cases are concerned with:

- Alteration of the articles for the purpose of **removing** a **director from office**
- Alteration of the articles to permit a majority of members to **enforce** a **transfer** to themselves of the shareholding of a minority

The action of the majority in altering the articles to achieve 'expulsion' will generally be treated as **valid** even though it is discriminatory, if the majority were concerned to **benefit the company** or to remove some detriment to its interests.

If on the other hand the majority was **blatantly seeking** to secure an **advantage** to themselves by their discrimination, the alteration made to the articles by their voting control of the company will be invalid. The cases below illustrate how the distinctions are applied in practice.

Shuttleworth v Cox Bros & Co (Maidenhead) Ltd 1927

The facts: Expulsion of director appointed by the articles who had failed to account for funds was held to be valid.

Sidebottom v Kershaw, Leese & Co Ltd 1920

The facts: The articles were altered to enable the directors to purchase at a fair price the shareholding of any member who competed with the company in its business. The minority against whom the new article was aimed did carry on a competing business. They challenged the validity of the alteration on the ground that it was an abuse of majority power to 'expel' a member.

Decision: There was no objection to a power of 'expulsion' by this means. It was a justifiable alteration if made *bona fide* in the interests of the company as a whole. On the facts this was justifiable.

Brown v British Abrasive Wheel Co 1919

The facts: The company needed further capital. The majority who held 98 per cent of the existing shares were willing to provide more capital but only if they could buy up the 2 per cent minority. As the minority refused to sell the majority proposed to alter the articles to provide for compulsory acquisition on a fair value basis. The minority objected to the alteration.

Decision: The alteration was invalid since it was merely for the benefit of the majority. It was not an alteration 'directly concerned with the provision of further capital' and therefore not for the benefit of the company.

Dafen Tinplate Co Ltd v Llanelly Steel Co (1907) Ltd 1920

The facts: The claimant was a minority shareholder which had transferred its custom from the defendant company to another supplier. The majority shareholders of the defendant company sought to protect their interests by altering the articles to provide for compulsory acquisition of the claimant's shares.

The new article was not restricted (as it was in *Sidebottom's* case above) to acquisition of shares on specific grounds where benefit to the company would result. It was simply expressed as a power to acquire the shares of a member. The claimant objected that the alteration was invalid since it was not for the benefit of the company.

Decision: The alteration was invalid because it 'enables the majority of the shareholders to compel any shareholder to transfer his shares'. This wide power could not 'properly be said to be for the benefit of the company'. The mere unexpressed intention to use the power in a particular way was not enough.

Therefore if the majority intend that the power to acquire the shares of a minority is to be restricted to specific circumstances for the benefit of the company, they should ensure that this restriction is included in the new article.

Exam focus point

Scenario questions on this area of law may concern a majority wishing to amend the company's articles to allow the expulsion of a minority (as in December 2008).

Question

Explain the nature of the model articles of association under the Companies Act 2006.

Answer

The model articles are a single document containing model rules and regulations concerning the management and administration of a company. They can be amended by the company but do not need to be to have effect.

2.2.6 Filing of alteration

Whenever any alteration is made to the articles a copy of the altered articles must be delivered to the Registrar within **15 days**, together with a signed copy of the special resolution making the alteration.

2.2.7 Interaction of statute and articles

There are two aspects to consider.

(a) The Companies Act may permit companies to do something **if** their **articles** also authorise it. For example a company may reduce its capital if its articles give power to do this. If, however, they do not, then the company must **alter** the articles to include the **necessary power** before it may exercise the statutory power.

(b) The Companies Act will **override** the articles:

   (i) If the Companies Act **prohibits something**

   (ii) If something is permitted by the Companies Act **only** by a **special procedure** (such as passing a special resolution in general meeting)

3 Company objects and capacity

FAST FORWARD

A **company's objects** are its aims and purposes. If a company enters into a contract which is outside its objects, that contract is said to be **ultra vires**. However, the rights of third parties to the contract are protected.

3.1 The objects

The objects are the **'aims'** and **'purposes'** of a company. Under previous companies legislation they were held in a specific clause within the memorandum of association. This clause set out everything the company could do, including being a 'general commercial company' which meant it could pretty much do anything.

The 2006 Act changed matters. The objects could now be found in the **articles** but most articles will **not** mention any objects. This is because under the Act a company's objects are **completely unrestricted** (ie it can carry out any lawful activity). Only where the company wishes to restrict its activities is there an inclusion of those **restrictions** in the articles: s 31.

3.1.1 Alteration of the objects

As a company's objects are located in its articles it may, under s 21, alter its objects by **special resolution** for any reason. The procedure is the same as for any other type of alteration.

3.2 Contractual capacity and *ultra vires*

FAST FORWARD

Companies may only act in accordance with their **objects**. If the directors permit an act which is restricted by the company's objects then the act is *ultra vires*.

Key term

Ultra vires is where a company exceeds its objects and acts outside its capacity.

Companies which have **unrestricted objects** are highly unlikely to act *ultra vires* since their constitution permits them to do anything. Where a company has restrictions placed on its objects and it breaches these restrictions then it would be acting *ultra vires*.

Ashbury Railway Carriage & Iron Co Ltd v Riche 1875

The facts: The company had an objects clause which stated that its objects were to make and sell, or lend on hire, railway carriages and wagons and all kinds of railway plant, fittings, machinery and rolling stock; and to carry on business as mechanical engineers. The company bought a concession to build a railway in Belgium, subcontracting the work to the defendant. Later the company repudiated the contract.

Decision: Constructing a railway was not within the company's objects so the company did not have capacity to enter into either the concession contract or the sub-contract. The contract was void for *ultra vires* and so the defendant had no right to damages for breach. The members could not ratify it and the company could neither enforce the contract nor be forced into performing its obligations.

The approach taken by the Companies Act 2006 is to give **security** to commercial transactions for **third parties**, whilst preserving the rights of shareholders to restrain directors from entering an *ultra vires action*.

S 39 provides as follows:

'the validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's constitution.'

S 40 provides as follows:

'in favour of a person dealing with a company in good faith, the power of the directors to bind the company, or authorise others to do so, shall be deemed to be free of any limitation under the company's constitution.'

There are a number of points to note about s 40.

(a) The section applies in favour of the **person dealing with the company**, it does not apply to the members.

(b) In contrast with s 39 **good faith** is required on the part of the third party. The company has, however, to prove lack of good faith in the third party and this may turn out to be quite difficult: s 40(2).

(c) The **third party** is not required to **enquire** whether or not there are any **restrictions** placed on the power of directors: s 40(2). They are free to assume the directors have any power they profess to have.

(d) The section covers not only acts beyond the capacity of the company, but acts beyond **'any limitation under the company's constitution'.**

While sections 39 and 40 deal with the company's transactions with **third parties**, the **members** may take action against the directors for permitting *ultra vires* acts. Their action will be based on the fact that the **objects specifically restricted** the particular act and under section 171, the **directors** must **abide** by the **company's constitution**.

The main problem for **members** is that they are most likely to be **aware** of the *ultra vires* act only **after** it has occurred. Therefore, they are not normally in a position to prevent it, although in theory they could seek an **injunction** if they found out about the potential *ultra vires* act before it took place.

Question — Capacity to contract

Describe how a company's capacity to contract can be regulated and what third parties may assume when entering into a contract with the company.

Answer

A company's capacity to contract is regulated by its members passing resolutions which restrict its objects. Under section 40(2) of the Act, third parties can assume the directors have the necessary power to authorise the act.

Exam focus point

Make sure you understand how s 39 and s 40 protect third parties.

3.3 Transactions with directors

S 41 of the Companies Act 2006 applies when the company enters into a contract with one of its **directors**, or its holding company, or any **person connected** with such a director. Contracts made between the company and these parties are **voidable** by the company if the director acts outside their capacity.

Whether or not the contract is avoided, the party and any authorising director is liable to repay any profit they made or make good any losses that result from such a contract.

4 The constitution as a contract

FAST FORWARD

The articles **constitute a contract** between:

- Company and members
- Members and the company
- Members and members

The articles **do not constitute** a contract between the **company** and **third parties**, or members in a **capacity** other than as **members** (the *Eley* case).

4.1 Effect

A company's constitution bind, under s 33:

- Members to company
- Company to members (but see below)
- Members to members

The company's constitution does **not** bind the company to third parties.

This principle applies only to rights and obligations which affect members **in their capacity as members**.

Hickman v Kent or Romney Marsh Sheepbreeders Association 1915

The facts: The claimant (H) was in dispute with the company which had threatened to expel him from membership. The articles provided that disputes between the company and its members should be submitted to arbitration. H, in breach of that article, began an action in court against the company.

Decision: The proceedings would be stayed since the dispute (which related to matters affecting H as a member) must, in conformity with the articles, be submitted to arbitration.

The principle that only rights and obligations of members are covered by s 33 applies when an outsider who is also a member seeks to rely on the articles in support of a claim made as an **outsider**.

Eley v Positive Government Security Life Assurance Co 1876

The facts: E, a solicitor, drafted the original articles and included a provision that the company must always employ him as its solicitor. E became a member of the company some months after its incorporation. He later sued the company for breach of contract in not employing him as its solicitor.

Decision: E could not rely on the article since it was a contract between the company and its members and he was not asserting any claim as a member.

4.2 Constitution as a contract between members

S 33 gives to the **constitution** the effect of a contract made between (a) the **company** and (b) its **members individually**. It can also impose a contract on the members in their dealings with each other.

Rayfield v Hands 1958

The facts: The articles required that (a) every director should be a shareholder and (b) the directors must purchase the shares of any member who gave them notice of his wish to dispose of them. The directors, however, denied that a member could enforce the obligation on them to acquire his shares.

Decision: There was 'a contract ... between a member and member-directors in relation to their holdings of the company's shares in its articles' and the directors were bound by it.

Articles and resolutions are usually **drafted** so that each stage is a dealing between the company and the members, to which s 33 clearly applies, so that:

(a) A member who intends to transfer his shares must, if the articles so require, give notice of his intention to the company.

(b) The company must then give notice to other members that they have an option to take up his shares.

4.3 Constitution as a supplement to contracts

FAST FORWARD

The constitution can be used to **establish the terms** of a contract existing elsewhere.

If an outsider makes a separate contract with the company and that contract contains no specific term on a particular point but the constitution does, then the contract is deemed to incorporate the constitution to that extent. One example is when services, say as a director, are provided under contract without agreement as to remuneration*: Re New British Iron Co, ex parte Beckwith 1898*.

If a contract incorporates terms of the articles it is subject to the company's **right** to **alter** its articles: *Shuttleworth v Cox Bros & Co (Maidenhead) Ltd 1927.* However a company's articles cannot be altered to deprive another person of a right already earned, say for services rendered **prior** to the alteration.

Point to note

Remember the articles only create contractual rights/obligations in relation to rights **as a member**.

4.4 Shareholder agreements

FAST FORWARD

Shareholders' agreements sometimes supplement a company's constitution.

Shareholder agreements are concerned with the **running of the company**; in particular they often contain terms by which the shareholders agree how they will vote on various issues.

They offer more protection to the interests of shareholders than do the articles of association. Individuals have a **power of veto** over any proposal which is contrary to the terms of the agreement. This enables a minority shareholder to protect his interests against unfavourable decisions of the majority.

Question — Constitution

State the parties who are bound by a company's articles.

Answer

The company is bound to the members, the members to the company and the members to the other members in their capacity as members.

5 Company name and registered office

FAST FORWARD

Except in **certain circumstances** a company's name must end with the words limited (Ltd), public limited company (plc) or the Welsh equivalents.

A company's name is its **identity.** There are a number of rules which restrict the choice of name that a company may adopt.

5.1 Statutory rules on the choice of company name

FAST FORWARD

No company may use a name which is:

– The **same** as an existing company on the Registrar's index of company names
– A **criminal offence, offensive,** or **'sensitive'**
– Suggest a **connection** with the **government or local authority** (unless approved)

The choice of name of a limited company must conform to the following rules.

(a) The name must **end** with the word(s):

(i) **Public limited company** (abbreviated **plc**) if it is a public company

(ii) **Limited** (or Ltd) if it is a private limited company, unless permitted to omit 'limited' from its name

(iii) The **Welsh equivalents** of either (i) or (ii) may be used by a Welsh company

(b) No company may have a name which is the **same** as any other existing company appearing in the statutory index at Companies House. For this purpose two names are treated as 'the same' in spite of minor or non-essential differences. For instance the word 'the' as the first word in the name is ignored. 'John Smith Limited' is treated the same as 'John Smith' (an unlimited company) or 'John Smith & Company Ltd'. Where a company has a name which is the same or too similar to another, the Secretary of State may direct the company to **change its name**.

(c) No company may have a name the use of which would be a **criminal** offence or which is considered **offensive** or **'sensitive'** (as defined by the Secretary of State).

(d) Official approval is required for a name which in the Registrar's opinion suggests a **connection** with the **government** or a **local authority** or which is subject to **control**.

A name which suggests some professional expertise such as 'optician' will only be permitted if the appropriate representative association has been consulted and raises no objection.

The general purpose of the rule is to **prevent** a company **misleading** the public as to its real circumstances or activities. Certain names may be approved by the Secretary of State on written application.

5.2 Omission of the word 'limited'

A private company which is a charity and a company limited by shares or guarantee and licensed to do so before 25 February 1982 may omit the word 'limited' from its name if the following conditions are satisfied.

(a) The objects of the company must be the **promotion** of either commerce, art, science, education, religion, charity or any profession (or anything incidental or conducive to such objects).

(b) The memorandum or articles must require that the **profits** or other income of the company are to be **applied to promoting** its objects and no dividends or return of capital may be paid to its members. Also on liquidation the **assets** (otherwise distributable to members) are to be **transferred** to another body with similar objects. The articles must not then be altered so that the company's status to omit 'Limited' is lost.

5.3 Change of name

A company may decide to change its name by:

(a) Passing a special resolution

(b) By **any other means** provided for in the **articles** (in other words the company can specify its own procedure for changing its name).

Where a **special resolution** has been passed, the **Registrar** should be notified and a copy of the resolution sent. If the change was made by **any other procedure** covered by (b), the Registrar should be notified and a statement provided which states that the change has been made in accordance with the articles.

The change is effective from when a new **incorporation certificate is issued**, although the company is still treated as the same legal entity as before. The same limitations as above apply to adoption of a name by change of name as by incorporation of a new company.

5.4 Passing-off action

A person who considers that their rights have been infringed can apply for an injunction to restrain a company from using a name (**even if** the name has been duly registered). It can do this if the name suggests that the latter company is carrying on the business of the complainant or is otherwise connected with it.

A company can be **prevented** by an **injunction** issued by the court in a **passing-off action** from **using** its **registered name**, if in doing so it causes its goods to be confused with those of the claimant.

Ewing v Buttercup Margarine Co Ltd 1917

The facts: The claimant had since 1904 run a chain of 150 shops in Scotland and the north of England through which he sold margarine and tea. He traded as 'The Buttercup Dairy Co'. The defendant was a registered company formed in 1916 with the name above. It sold margarine as a wholesaler in the London area. The defendant contended that there was unlikely to be confusion between the goods sold by the two concerns.

Decision: An injunction would be granted to restrain the defendants from the use of its name since the claimant had the established connection under the Buttercup name. He planned to open shops in the south of England and if the defendants sold margarine retail, there could be confusion between the two businesses.

If, however, the two companies' businesses are different, confusion is unlikely to occur, and hence the courts will refuse to grant an injunction: *Dunlop Pneumatic Tyre Co Ltd v Dunlop Motor Co Ltd 1907*

The complaint will not succeed if the claimant lays claim to the exclusive use of a word which has a general use: *Aerators Ltd v Tollit 1902.*

5.5 Appeal to the Company Names Adjudicators

A company which feels that another company's name is **too similar** to its own may object to the Company Names Adjudicator under the Companies Act. The Adjudicator will review the case and, within **90 days**, make their decision and provide their reasons for it in public. In most cases the Adjudicator will require the offending company to **change its name** to one which does not breach the rules. In some cases the **Adjudicator may determine** the new name.

An appeal against the decision may be made in Court. The Court may **reverse** the Adjudicator's decision, **affirm** it and may even **determine** a new name.

Question

Company name

Do It Yourself Ltd was incorporated on 1 September 20X7. On 1 October 20X7 the directors received a letter from DIY Ltd stating that it was incorporated in 19X4, that its business was being adversely affected by the use of the new company's name, and demanding that Do It Yourself Ltd change its name.

Advise Do It Yourself Ltd.

Answer

DIY Ltd may seek to bring a 'passing-off action'. This is a common law action which applies when one company believes that another's conduct (which may be the use of a company name) is causing confusion in the minds of the public over the goods which each company sells. DIY Ltd would apply to the court for an injunction to prevent Do It Yourself Ltd from using its name.

However, in order to be successful, DIY Ltd will need to satisfy the court that confusion has arisen because of Do It Yourself Ltd's use of its registered name and that it lays claim to something exclusive and distinctive and not something in general use: *Aerators Ltd v Tollit 1902*.

Appeal to Company Names Adjudicator

Alternatively DIY Ltd might object to the Company Names Adjudicator that the name Do It Yourself Ltd is too like its own name and is causing confusion, thus appealing to compel a change of name. In these circumstances, the Adjudicator would hear the case and make a decision. If they compel a name change Do It Yourself Ltd may appeal to the court.

5.6 Publication of the company's name

The company's name must appear legibly and conspicuously:

- Outside the registered office and all places of business.
- On all business letters, order forms, notices and official publications.
- On all **receipts** and **invoices** issued on the company's behalf.
- On all **bills of exchange**, **letters of credit**, **promissory notes**, **cheques** and **orders** for money or goods purporting to be signed by, or on behalf, of the company
- On its **website**

5.7 Business names other than the corporate name

Key term

> A **business name** is a name used by a company which is different from the company's corporate name or by a firm which is different from the name(s) of the proprietor or the partners.

Most companies trade under their own registered names. However a company may prefer to use some other name. If it does so it becomes subject to the **Business Names Act 1985** (to be repealed by Schedule 16 of the Companies Act 2006 in October 2008).

The rules require any person (company, partnership or sole trader) who carries on business under a different name from his own:

(a) To **state** its **name**, registered **number** and registered **address** on all **business letters (including emails)**, invoices, receipts, written orders for goods or services and written demands for payment of debts.

(b) To **display** its **name** and **address** in a **prominent position** in any **business premises** to which its customers and suppliers have access.

(c) On **request** from any **person** with whom it does business to give **notice** of its name and address.

5.8 Registered office

Section 86 of the Companies Act 2006 provides that a company must at all times have a **registered office** to which all communications and notices can be sent. It may **change its registered office** under section 87 by notifying the Registrar, but for a period of 14 days after notice is served any person may validly present documents to the previous address.

5.9 Company names in Europe

Some other EU members have stricter rules associated with company names than the UK. In France, a SARL must have a name which is either descriptive of the business **or** contains the name of a member of that company. The same is true in Germany of a GmbH.

Contrastingly, in France, an SA must **not** contain the name of a member, but must indicate the **object** of the company **and** the locality of the company. In Germany, an AG must also usually indicate the object of the company in its name.

Chapter Roundup

- The memorandum is a **simple document** which states that the subscribers wish to form a company and become members of it.
- A **company's constitution** comprises the **Articles of Association** and any **resolutions and agreements** it makes which affect the constitution.
- The articles may be altered by a **special resolution**. The basic test is whether the alteration is for the **benefit of the company as a whole**.
- A **company's objects** are its aims and purposes. If a company enters into a contract which is outside its objects, that contract is said to be **ultra vires**. However, the rights of third parties to the contract are protected.
- Companies may only act in accordance with their **objects**. If the directors permit an act which is restricted by the company's objects then the act is *ultra vires*.
- The articles **constitute** a **contract** between:
  - Company and members
  - Members and the company
  - Members and members

  The articles **do not constitute** a contract between the **company** and **third parties**, or members in a **capacity** other than as **members** (the *Eley* case).
- The constitution can be used to **establish the terms** of a contract existing elsewhere.
- **Shareholders' agreements** sometimes supplement a company's constitution.
- Except in **certain circumstances** the name must end with the words limited (Ltd), public limited company (plc) or the Welsh equivalents.
- No company may use a name which is:
  - The **same** as an existing company on the Registrar's index of company names
  - A **criminal offence, offensive** or **'sensitive'**
  - Suggest a **connection** with the **government** or **local authority** (unless approved)

Quick Quiz

1 Percy Limited has recently formed a contract with a third party which is restricted by the objects in the company's constitution.

Which of the following statements is incorrect?

A The validity of the act cannot be questioned on the grounds of lack of capacity by reason of anything in the company's constitution.

B The act may be restrained by the members of Percy Ltd.

C The act may be enforced by the company and the third party.

D The directors have a duty to observe any limitation on their powers flowing from the company's constitution.

2 If a company wishes to restrict its objects, what kind of resolution is required?

A Special resolution
B Special resolution with special notice
C Ordinary resolution with special notice
D Ordinary resolution

3 A company has been formed within the last six months. Another long-established company considers that because of similarity there may be confusion between it and the new company. The only action the long-established company can take is to bring a passing-off action if it is to prevent the new company using its name.

True ☐

False ☐

4 Which of the following persons are not bound to one another by the constitution?

A Members to company
B Company to members
C Members to members
D Company to third parties

5 How long does a company have to file amended articles with the Registrar if they have been altered?

A 14 days
B 15 days
C 21 days
D 28 days

Answers to Quick Quiz

1 A, C and D are true. Members can only act before the contract is signed, so B is incorrect.

2 A. A special resolution is required to restrict the objects as with any alteration to the articles in general.

3 False. The long-established company can also complain to the Company Names Adjudicator.

4 A, B and C are correct: s 33. D is incorrect, illustrated by *Eley v Positive Government Security Life Assurance Co Ltd 1876.*

5 B. A company has 15 days to file amended articles with the Registrar.

Now try the questions below from the Exam Question Bank

Number	Level	Marks	Time
Q12	Examination	10	18 mins
Q13	Examination	10	18 mins

PART E

Capital and financing of companies

12

Share capital

Topic list	Syllabus reference
1 Members	E1(a)
2 The nature of shares and capital	E1(a)
3 Types of share	E1(b), E1(c)
4 Allotment of shares	E1(a)

Introduction

In this chapter the nature of share capital is explained. You should note (and **not** confuse) the different types of capital that are important for company law purposes.

The rest of the chapter discusses procedural matters relating to the **issue** and **transfer** of shares. You will see that there are built-in safeguards to protect members' rights, **pre-emption rights** and the necessity for directors to be authorised to **allot** shares. There are also safeguards that ensure that a company receives **sufficient consideration** for its shares. This is an aspect of **capital maintenance**, which we discuss further in Chapter 14.

Study guide

		Intellectual level
E	**Capital and the financing of companies**	
1	**Share capital**	
(a)	Examine the different meanings of capital	2
(b)	Illustrate the difference between various classes of shares	2
(c)	Explain the procedure for altering class rights	2

Exam guide

Share capital is an important syllabus area that lends itself well to different types of question. You may be required to distinguish between different types of share and explain what class rights are and how they can be altered.

1 Members

FAST FORWARD

A member of a company is a person who has **agreed to become a member**, and whose name has been **entered** in the **register of members**. This may occur by: subscription to the memorandum; applying for shares; the presentation to the company of a transfer of shares to the prospective member; applying (as personal representative of a deceased member or a trustee of a bankrupt).

1.1 Becoming a member

Key term

A **member** of a company is a person who has agreed to be a member and whose name has been entered in the register of members.

Entry in the register is **essential**. Mere delivery to the company of a transfer does not make the transferor a member – until the transfer is entered in the register.

1.2 Subscriber shares

Subscribers to the memorandum are deemed to have agreed to become members of the company. As soon as the company is formed their names should be entered in the register of members.

Other persons may acquire shares and become members:

- By **applying** and being allotted shares
- By presenting to the company for registration a **transfer** of shares to them
- By applying as personal representative or trustee of a
  - Deceased member
  - Bankrupt member

1.3 Ceasing to be a member

FAST FORWARD

There are **eight** ways in which a member ceases to be so.

A member ceases to be a member in any of the following circumstances.

- He **transfers** all his shares to another person and the transfer is registered.
- The member **dies**.

- The **shares** of a bankrupt member are **registered** in the name of his trustee.
- A member who is a minor repudiates his shares.
- The trustee of a bankrupt member disclaims his shares.
- The company forfeits or accepts the surrender of shares.
- The **company** sells them in exercise of a lien.
- The **company is dissolved** and **ceases to exist.**

1.4 The number of members

FAST FORWARD

Public and private companies must have a minimum of **one** member (s 7). There is **no maximum** number**.**

Public and private companies must have a minimum **of one member** (s 7). There is **no maximum** number. Where a company has a sole member, the following rules will apply.

(a) The **register of members** must contain a statement that there is **only one member** and give his address.

(b) Quorum. The Act automatically permits a quorum of one for general meetings.

2 The nature of shares and capital

FAST FORWARD

A **share** is a transferable form of property, carrying rights and obligations, by which the interest of a member of a company limited by shares is measured.

2.1 Shares

Key term

A **share** is 'the interest of a shareholder in the company measured by a sum of money, for the purpose of a liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders *inter se*': *Borland's Trustee v Steel Bros & Co Ltd 1901.*

The key points in this definition are:

(a) The share must be **paid for** ('liability'). The nominal value of the share fixes this liability, it is the base price of the share eg a $1 ordinary share.

(b) It gives a **proportionate entitlement** to dividends, votes and any return of capital ('interest').

(c) It is a form of **bargain** ('mutual covenants') between shareholders which underlies such principles as majority control and minority protection.

Key term

A share's **nominal value** is its face value. So a $1 ordinary share for instance, has a nominal value of $1. No share can be issued at a value below its nominal value.

A share is a form of personal property, carrying rights and obligations. It is by its nature **transferable**.

A member who holds one or more shares is a **shareholder**. However, some companies (such as most companies limited by guarantee) do not have a share capital. So they have members who are not also shareholders.

Information about any special rights attached to shares is obtainable from one of the following documents which are on the file at Companies House:

(a) The **articles**, which are the normal context in which share rights are defined.

(b) A **resolution** or agreement incidental to the creation of a new class of shares (copies must be delivered to the Registrar).

(c) A **statement of capital** given to the Registrar within one month of **allotment**, together with the return of allotment.

2.2 Types of capital

FAST FORWARD

The term '**capital**' is used in several senses in company legislation, to mean issued, allotted or called up share capital or loan capital.

2.2.1 Authorised share capital

Under previous company legislation, companies had to specify a **maximum authorised share capital** that it could issue. Under the 2006 Act, the concept of authorised share capital was removed.

2.2.2 Issued and allotted share capital

Key term

Issued and allotted share capital is the type, class, number and amount of the shares issued and allotted to specific shareholders, including shares taken on formation by the subscribers to the memorandum

A company need not issue all its share capital at once. If it retains a part, this is **unissued share capital**. **Issued share** capital can be **increased** through the allotment of shares (s 617), see Section 4.

Rights issues and the issue of **bonus shares** (see later) will also increase the amount of a company's capital.

2.2.3 Called up and paid up share capital

Key terms

Called up share capital is the amount which the company has required shareholders to pay now or in the future on the shares issued.

Paid up share capital is the amount which shareholders have actually paid on the shares issued and called up.

For example a company has issued and allotted 70 $1 (nominal value) shares, has received 25c per share on application and has called on members for a second 25c. Therefore its issued and allotted share capital is $70 and its **called up** share capital is $35 (50c per share). When the members pay the call, the **'paid up'** share capital is then $35 also. Capital not yet called is **'uncalled capital'**. Called capital which is not yet paid is termed **'partly paid'**; the company therefore has an outstanding claim against its shareholders and this debt is transferred to the new shareholder if the share is transferred.

As we saw earlier, on allotment public companies must receive at least one quarter of the nominal value of the shares paid up, plus the whole of any premium.

2.2.4 Loan capital

Key term

Loan capital comprises debentures and other long-term loans to a business.

Loan capital, in contrast with the above, is the term used to describe **borrowed money** obtained usually by the issue of debentures. **It is nothing to do with shares**.

Attention!

We shall look at loan capital in detail in Chapter 13.

2.3 Market value

Shares of a public company are freely transferable (providing the appropriate procedures are followed) and therefore may be subsequently sold by some or all of the shareholders. The sale price will not necessarily be the nominal value, rather it will reflect the prospects of the company and therefore may be greater or less than the nominal value.

3 Types of share

FAST FORWARD

If the constitution of a company states no differences between shares, it is assumed that they are all **ordinary** shares with parallel rights and obligations. There may, however, be other types, notably **preference shares** and **redeemable shares**.

3.1 Ordinary shares (equity)

If no differences between shares are expressed then all shares are equity shares with the **same rights**, known as ordinary shares.

Key terms

Equity is the residual interest in the assets of the company after deducting all its liabilities. It comprises issued share capital excluding any part of that capital that does not carry any right to participate beyond a specified amount in a distribution.

Equity share capital is a company's issued share capital less capital which carries preferential rights.

Ordinary shares are shares which entitle the holders to the remaining divisible profits (and, in a liquidation, the assets) after prior interests, eg creditors and prior charge capital, have been satisfied.

Exam focus point

Exam questions in this area often require an explanation of the types of share (as in June 2008) or explanations of share terminology (as in December 2008).

3.2 Class rights

Key term

Class rights are rights which are attached to particular types of shares by the company's constitution.

A company may at its option attach special rights to different shares regarding:

- Dividends
- Return of capital
- Voting
- The right to appoint or remove a director

Any share which has different rights from others is grouped with the other shares carrying identical rights to form a **class**.

The most common types of share capital with different rights are **preference shares** and **ordinary shares**. There may also be ordinary shares with voting rights and ordinary shares without voting rights.

3.3 Preference shares

FAST FORWARD

The most common right of preference shareholders is a **prior right** to receive a fixed dividend. This right is not a right to **compel payment** of a dividend, but it is **cumulative** unless otherwise stated. Usually, preference shareholders **cannot participate** in a dividend over and above their fixed dividend and **cease to be entitled to arrears of undeclared dividends** when the company goes into liquidation.

Key term

Preference shares are shares carrying one or more rights such as a fixed rate of dividend or preferential claim to any company profits available for distribution.

A preference share may and generally will carry a **prior right** to receive an annual dividend of fixed amount, say a dividend of 6% of the share's nominal value.

Ordinary and preference shares are deemed to have identical rights. However, a company's articles or resolutions may create differences between them.

As regards the priority dividend entitlement, four points should be noted.

(a) **The right is merely to receive a dividend at the specified rate before any other dividend may be paid or declared**. It is **not** a right to compel the company to pay the dividend, *(Bond v Barrow Haematite Steel Co 1902)*. The company can decline to pay the dividend if it decides to transfer available profits to reserves instead of using the profits to pay the preference dividend.

(b) **The right to receive a preference dividend is deemed to be cumulative unless the contrary is stated**. If, therefore, a 6% dividend is not paid in Year 1, the priority entitlement is normally carried forward to Year 2, increasing the priority right for that year to 12% – and so on.

When arrears of cumulative dividend are paid, the holders of the shares at **the time when the dividend is declared** are entitled to the whole of it even though they did not hold the shares in the year to which the arrears relate.

An intention that preference shares should not carry forward an entitlement to arrears is usually expressed by the word **'non-cumulative'**.

(c) If a company which has arrears of unpaid cumulative preference dividends goes into liquidation, the preference shareholders cease to be entitled to the arrears unless:

(i) A **dividend** has been **declared** though **not yet paid** when liquidation commences.

(ii) The **articles** (or other terms of issue) **expressly provide** that in a liquidation arrears are to be paid in priority to return of capital to members.

(d) **Holders of preference shares have no entitlement to participate in any additional dividend over and above their specified rate**. If, for example, a 6% dividend is paid on 6% preference shares, the entire balance of available profit may then be distributed to the holders of ordinary shares.

This rule also may be expressly overridden by the terms of issue. For example, the articles may provide that the preference shares are to receive a priority 6% dividend and are also to participate equally in any dividends payable after the ordinary shares have received a 6% dividend. Preference shares with these rights are called **participating preference shares**.

In all other respects preference shares carry the **same** rights as ordinary shares **unless otherwise stated**. If they do rank equally they carry the same rights, no more and no less, to return of capital, distribution of surplus assets and voting.

In practice, it is unusual to issue preference shares on this basis. More usually, it is expressly provided that:

(a) The preference shares are to carry a **priority right** to **return of capital**.

(b) They are **not to carry a right to vote, or voting is permitted in specified circumstances**. For example, failure to pay the preference dividend, variation of their rights or a resolution to wind up.

When preference shares carry a **priority right** to **return** of **capital** the result is that:

(a) The amount paid up on the preference shares, say $1 on each $1 share, is to be repaid in liquidation before anything is repaid to ordinary shareholders.

(b) Unless otherwise stated, the holders of the preference shares are **not** entitled to share in surplus assets when the ordinary share capital has been repaid.

3.3.1 Advantages and disadvantages of preference shares

The advantages of preference shares are **greater security of income** and (if they carry priority in repayment of capital) **greater security of capital**. However, in a period of persistent inflation, the benefit of entitlement to fixed income and to capital fixed in money terms is an illusion.

A number of other drawbacks and pitfalls, such as loss of arrears, winding up and enforced payment, have been indicated above. Preference shares may be said to fall between the two stools of risk and reward (as seen in ordinary shares) and security (debentures).

3.3.2 Example: Sharia law

Muslim companies would not issue **preference shares** of this nature as the fixed interest element would amount to **riba**, or unlawful gain.

3.4 Variation of class rights

FAST FORWARD

The holders of **issued** shares have **vested rights** which can only be varied by using a strict procedure. The standard procedure is by **special resolution** passed by at least **three quarters** of the votes cast at a **separate class meeting** or by written consent.

Key term

A **variation of class rights** is an alteration in the position of shareholders with regard to those rights or duties which they have by virtue of their shares.

The holders of issued shares have **vested rights** which can only be varied by the company with the consent of all the holders or with such consent of a majority as is specified (usually) in the articles.

The standard procedure for variation of class rights requires that a **special resolution** shall be passed by a **three quarters majority** cast either at a **separate meeting** of the class, or by **written consent**: s 630.

If any other requirements are imposed by the company's articles then these must also be followed.

3.4.1 When variation rules apply

FAST FORWARD

It is **not** a variation of class rights to issue shares to new members, to subdivide shares of another class, to return capital to preference shareholders, or to create a new class of preference shareholders.

It is only necessary to follow the variation of class rights procedure **if what is proposed amounts to a variation of class rights**. There are many types of transaction that do not actually constitute a variation of class rights.

3.4.2 Examples: not a variation of class rights

(a) **To issue shares of the same class to allottees who are not already members of the class** (unless the defined class rights prohibit this).

White v Bristol Aeroplane Co Ltd 1953

The facts: The company made a bonus issue of new ordinary and preference shares to the existing ordinary shareholders who alone were entitled under the articles to participate in bonus issues. The existing preference shareholders objected. They stated that reducing their proportion of the class of preference shares (by issuing the bonus of preference shares) was a variation of class rights to which they had not consented.

Decision: This was not a variation of class rights since the existing preference shareholders had the same number of shares (and votes at a class meeting) as before.

(b) **To subdivide shares of another class with the incidental effect of increasing the voting strength of that other class.**

Greenhalgh v Arderne Cinemas Ltd 1946

The facts: The company had two classes of ordinary shares, 50p shares and 10p shares. Every share carried one vote. A resolution was passed to subdivide each 50p share into five 10p shares, thus multiplying the votes of that class by five.

Decision: The rights of the original 10p shares had not been varied since they still had one vote per share as before.

(c) **To return capital to the holders of preference shares**: *House of Fraser plc v ACGE Investments Ltd 1987.*

(d) **To create and issue a new class of preference shares with priority over an existing class of ordinary shares**: *Re John Smith's Tadcaster Brewery Co Ltd 1953.*

The cases cited in the preceding paragraph illustrate the principle that without a '**literal variation'** of class rights there is no alteration of rights to which the safeguards of proper procedure and appeal to the court (see below) apply. The fact that the **value** of existing rights may be affected will not concern the court if the rights are unchanged.

Exam focus point

Knowledge of what does **not** constitute a variation of class rights is vital in this area.

3.4.3 Special situations

To deal with unusual special situations which in the past caused some difficulty, the following rules apply.

(a) If the class rights are set **by the articles and** they **provide** a **variation procedure**, that procedure must be followed for any variation even if it is less onerous than the statutory procedure.

(b) If class **rights** are **defined otherwise than by the articles** and there is **no variation procedure**, consent of a **three quarters majority** of the class is both necessary and sufficient.

The rules on notice, voting, polls, circulation of resolutions and quorum relating to general meetings relate also to class meetings when voting on alteration of class rights. We shall come back to these in Chapter 16.

3.4.4 Minority appeals to the court for unfair prejudice

FAST FORWARD

A **dissenting minority** holding 15% or more of the issued shares may apply to the court within 21 days of class consent to have the variation cancelled as 'unfairly prejudicial'.

Whenever class rights are varied under a procedure contained in the constitution; a minority of holders of shares of the class may apply to the court to have the variation cancelled. The objectors together must:

- Hold **not less** than **15**% of the **issued shares** of the class in question
- **Not** themselves have **consented** to or voted in favour of the variation
- **Apply** to the court within **21 days** of the consent being given by the class s 633.

The court can either approve the variation as made or cancel it as 'unfairly prejudicial'. It cannot, however, modify the terms of the variation.

To establish that a variation is 'unfairly prejudicial' to the class, the minority must show that the majority was seeking **some advantage** to themselves as **members** of a **different class** instead of considering the interests of the class in which they were then voting.

3.5 Redeemable shares

Redeemable shares, which are shares issued on terms that they may be bought back by a company either at a future specific date or at the shareholder's or company's option, are discussed further in Chapter 14.

Question — **Types of share**

Give brief definitions of the following types of share.

(a) Equity share
(b) Ordinary share
(c) Preference share

BPP LEARNING MEDIA

Answer

(a) An equity share is a share which gives the holder the right to participate in the company's surplus profit and capital. In a winding up the holder is entitled to a repayment of the nominal value plus a share of surplus assets. The term equity share embraces ordinary shares, but also includes a preference shares when the terms of issue include either the right to an additional dividend or the right to surplus assets in a winding up.

(b) An ordinary share is the more common type of equity share, as discussed in (a) above. The dividend is payable only when preference dividends, including arrears, have been paid.

(c) Preference shares carry a prior right to receive an annual dividend of a fixed amount, usually as a percentage of the share's nominal value. There are no other implied differences between preference and ordinary shares, although there may be express differences between them. For example, the preference shares may carry a priority right to return of capital. Generally preference shares do not carry voting rights in the company other than those relating to their own class. Unless otherwise stated, dividends allocated to preference shares are assumed to be cumulative. This means that, if the company does not make sufficient profits to pay a dividend in one year, the arrears are carried forward to future years.

3.6 Statement of capital

We have already seen, in Chapter 10 Section 3 (registration of the company) and above in Section 2 (rights of shares), that a return known as a **statement of capital** is required to be made to the **Registrar** in certain circumstances.

The statement of capital must give the following details in respect of the **share capital** of the company and be **up to date** as of the statement date.

(a) The total number of shares of the company

(b) The aggregate nominal value of the shares

(c) For **each class** of share:

- (i) The **prescribed particulars** of any rights attached
- (ii) The total number of shares in the class
- (iii) The **aggregate nominal value** of shares in the class

(d) The **amount paid up** and the **amount (if any) unpaid** on each share, either on account of the nominal value of the share or by way of premium.

(e) **Information that identifies the subscribers to the memorandum of association**.

(f) In respect of each **subscriber**, the **number**, **nominal value** and **class of shares** taken by them on formation and the **amount** to be **paid up**.

4 Allotment of shares

FAST FORWARD

Directors exercise the **delegated power** to allot shares, either by virtue of the articles or a resolution in general meeting.

4.1 Definition

Key term

Allotment of shares is the issue and allocation to a person of a certain number of shares under a contract of allotment. Once the shares are allotted and the holder is entered in the register of members, the holder becomes a member of the company. The member is issued with a share certificate.

The allotment of shares is a **form of contract**. The intending shareholder applies to the company for shares, and the company accepts the offer.

The terms 'allotment' and 'issue' have slightly different meanings.

(a) A share is **allotted** when the person to whom it is allotted acquires an unconditional right to be entered in the register of members as the holder of that share. That stage is reached when the board of directors (to whom the power to allot shares is usually given) considers the application and formally resolves to allot the shares.

However if the directors imposed a condition, for instance that the shares should be allotted only on receipt of the subscription money, the allotment would only take effect when payment was made.

(b) The **issue** of shares is not a defined term but is usually taken to be a later stage at which the allottee **receives** a **letter of allotment** or share certificate issued by the company.

The allotment of shares of a private company is a simple and immediate matter. The name of the allottee is usually entered in the register of members soon after the allotment of shares to him. They then become a member.

4.2 Public company allotment of shares

There are various methods of selling shares to the public.

Key terms

Public offer: where members of the public subscribe for shares directly to the company.

Offer for sale: an offer to members of the public to apply for shares based on information contained in a prospectus

Placing: a method of raising share capital where shares are offered in a small number of large 'blocks', to persons or institutions who have previously agreed to purchase the shares at a predetermined price.

In order to encourage the public to buy shares in a public company, it may issue a prospectus, or in the case of a company listed on the Stock Exchange, listing particulars. Listing particulars are subject to rules set down by the UK Listing Authority (part of the Financial Services Authority).

4.3 Private company allotment of shares

The allotment of shares in a private company is more straightforward. The rule to remember is that private companies cannot sell shares to the public. An application must be made to the directors directly. After that shares are allotted and issued, and a return of allotment made to the Registrar, as for a public company.

4.4 Directors' powers to allot shares

Directors of **private companies** with **one class of share** have the **authority** to allot shares **unless restricted** by the articles.

Directors of **public companies** or **private companies with more than one class of share may not allot shares** (except to subscribers to the memorandum and to employees' share schemes) **without authority from the members.**

4.5 Pre-emption rights: s 561

FAST FORWARD

If the directors propose to allot 'equity securities' wholly for cash, there is a general requirement to offer these shares to **holders** of **similar shares** in proportion to their holdings.

Key term

Pre-emption rights are the rights of existing ordinary shareholders to be offered new shares issued by the company *pro rata* to their existing holding of that class of shares.

If a company proposes to allot ordinary shares wholly for cash it has a **statutory obligation** to offer those shares first to holders of similar shares in **proportion to their holdings** and on the same or more favourable terms as the main allotment. This is known as a **rights issue**.

4.6 Rights issues

Key term

> A **rights issue** is a right given to a shareholder to subscribe for further shares in the company, usually *pro rata* to their existing holding in the company's shares.

A rights issue must be made **in writing** (hard copy or electronic) in the same manner as a notice of a general meeting is sent to members. It must specify a period of **not less than 21 days** during which the offer may be accepted but may not be withdrawn. If not accepted or renounced in favour of another person within that period the offer is deemed to be declined.

Equity securities which have been offered to members in this way but are **not accepted** may then be allotted on the same (or less favourable) terms to non-members.

If equity securities are allotted in breach of these rules the members to whom the offer should have been made may within the ensuing two years recover **compensation** for their loss from those in default. The allotment will generally be valid.

4.6.1 Exclusion of pre-emption rights: s 567

A **private** company may by its articles permanently exclude these rules so that there is no statutory right of first refusal.

4.6.2 Disapplication of pre-emption rights: s 570

Any company may, by special resolution resolve that the statutory right of first refusal shall not apply: s 570. Such a resolution to 'disapply' the right may either:

(a) Be combined with the grant to directors of authority to allot shares, or

(b) Simply permit an offer of shares to be made for cash to a non-member (without first offering the shares to members) on a particular occasion

In case (b) the directors, in inviting members to 'disapply' the right of first refusal, must issue a circular. This sets out their reasons, the price at which the shares are to be offered direct to a non-member and their justification of that price.

4.7 Bonus issues

Key term

> A **bonus issue** is the capitalisation of the reserves of a company by the issue of additional shares to existing shareholders, in proportion to their holdings. Such shares are normally fully paid-up with no cash called for from the shareholders.

A bonus issue is more correctly but less often called a '**capitalisation issue**' (also called a 'scrip' issue). The articles of a company usually give it power to apply its reserves to paying up unissued shares wholly or in part and then to allot these shares as a bonus issue to members.

Chapter Roundup

- A member of a company is a person who has **agreed to become a member**, and whose name has been **entered** in the **register of members**. This may occur by: subscription to the memorandum; applying for shares; the presentation to the company of a transfer of shares to the prospective member: applying as personal representative of a deceased member or a trustee of a bankrupt.
- There are **eight** ways in which a member ceases to be so.
- **Public** and **private companies** must have a minimum of **one** member (s 7). There is **no maximum** number.
- A **share** is a transferable form of property, carrying rights and obligations, by which the interest of a member of a company limited by shares is measured.
- The term '**capital**' is used in several senses in company legislation, to mean issued, allotted or called up share capital or loan capital.
- If the constitution of a company states no differences between shares, it is assumed that they are all **ordinary** shares with parallel rights and obligations. There may, however, be other types, notably **preference shares** and **redeemable shares**.
- The most common right of preference shareholders is a **prior right** to receive a fixed dividend. This right is not a right to **compel payment** of a dividend, but it is **cumulative** unless otherwise stated. Usually, preference shareholders **cannot participate** in a dividend over and above their fixed dividend and **cease to be entitled to arrears of undeclared dividends** when the company goes into liquidation.
- The holders of **issued** shares have **vested rights** which can only be varied by using a strict procedure. The standard procedure is by **special resolution** passed by at least **three quarters** of the votes cast at a **separate class meeting** or by written consent.
- It is **not** a variation of class rights to issue shares to new members, to subdivide shares of another class, to return capital to preference shareholders, or to create a new class of preference shareholders.
- A **dissenting minority** holding 15% or more of the issued shares may apply to the court within 21 days of class consent to have the variation cancelled as 'unfairly prejudicial'.
- Directors exercise the **delegated power** to allot shares, either by virtue of the articles or a resolution in general meeting.
- If the directors propose to allot 'equity securities' wholly for cash, there is a general requirement to offer these shares to **holders** of **similar shares** in proportion to their holdings.

Quick Quiz

1 If a company fails to pay preference shareholders their dividend, they can bring a court action to compel the company to pay it.

True ☐

False ☐

2 Which two of the following are implied rights of preference shareholders?

A The right to receive a dividend is cumulative.

B If the company goes into liquidation, preference shareholders are entitled to claim all arrears of dividend from the liquidator.

C As well as rights to their preference dividends, preference shareholders can share equally in dividends payable to ordinary shareholders.

D Preference shareholders have equal voting rights to ordinary shareholders.

3 If a company issues new ordinary shares for cash, the general rule is that:

A The shares must first be offered to existing members in the case of a public but not a private company.
B The shares must first be offered to existing members whether the company is public or private.
C The shares must first be offered to existing members in the case of a private but not a public company.
D The shares need not be issued to existing members.

4 **Fill in the blanks** in the statements below.

A ……………….. issue is an allotment of additional shares to existing members in exchange for consideration payable by the members.

A ……………….. issue is an allotment of additional shares to existing members where the consideration is paid by using the company's reserves.

5 **Fill in the blanks** in the statements below.

If there has been a variation of class rights, a minority of holders of shares of the class (who have not consented or voted in favour of the variation) may apply to the court to have the variation cancelled. The objectors must hold not less than ……………….. of the issued shares of that class, and apply to the court within ……………….. days of the giving of consent by that class.

6 What is the minimum number of members that a plc must have?

A One
B Two
C Three
D Four

7 Match the definitions to the correct type of capital.

(a) Issued share capital
(b) Called up share capital
(c) Paid up share capital

(i) The amount which the company has required shareholders to pay on shares issued.
(ii) The type, class, number and amount of the shares held by the shareholders.
(iii) The amount which shareholders have actually paid on the shares issued and called up.

Answers to Quick Quiz

1 False. The company may decide not to pay any dividend, or may be unable to because it does not have any distributable profits. What the preference shareholders have is a right to receive their dividends before other dividends are paid or declared.

2 A and D are implied rights; the others have to be stated explicitly.

3 B. The shares must be first offered to existing members whether the company is public or private.

4 A **rights issue** is an allotment of additional shares to existing members in exchange for consideration payable by the members.

A **bonus issue** is an allotment of additional shares to existing members where the consideration is effectively paid by using the company's reserves.

5 If there has been a variation of class rights, a minority of holders of shares of the class (who have not consented or voted in favour of the variation) may apply to the court to have the variation cancelled. The objectors must hold not less than **15%** of the issued shares of that class, and apply to the court within **21** days of the giving of consent by that class.

6 A. All companies must have a minimum of one member (s 7).

7 (a) (ii)
(b) (i)
(c) (iii)

Now try the question below from the Exam Question Bank

Number	Level	Marks	Time
Q14	Examination	10	18 mins

13 Borrowing and loan capital

Topic list	Syllabus reference
1 Borrowing	E3(a)
2 Debentures and loan capital	E2(b), E2(c)
3 Charges	E2(d)
4 Registration of charges	E2(e)
5 Debentureholders' remedies	E2(b)

Introduction

The last chapter was concerned with share capital. In this chapter on borrowing and **loan capital**, you should note that the interests and position of a lender is very different from that of a shareholder.

This chapter covers how loan capital holders protect themselves, specifically through taking out **fixed or floating charges**.

You need to understand the differences between fixed and floating charges, and also how they can protect loan creditors, for example by giving chargeholders the ability to appoint a **receiver**.

Study guide

		Intellectual level
E2	**Loan capital**	
(a)	Define companies' borrowing powers	1
(b)	Explain the meaning of debenture	2
(c)	Distinguish loan capital from share capital	2
(d)	Explain the concept of a company charge and distinguish between fixed and floating charges	2
(e)	Describe the need and the procedure for registering company charges	2

Exam guide

Loan capital is most likely to crop up in a knowledge question. Together with insolvency and corporate finance in general, however, it is a topic that could also be examined in a scenario question.

You may be required to identify instances where a company has exceeded its borrowing powers or to explain the differences between types of charges.

1 Borrowing

FAST FORWARD

Companies have an **implied power** to borrow for purposes incidental to their trade or business.

All companies registered under the Companies Act 2006 have an **implied power to borrow** for purposes **incidental to their trade or business**. A company formed under earlier Acts will have an implied power to borrow if its object is to carry on a trade or business.

In delegating the company's power to borrow to the directors it is usual, and essential in the case of a company whose shares are quoted on the Stock Exchange, to impose a **maximum limit** on the **borrowing** arranged by directors.

A contract to repay borrowed money may in principle be unenforceable if either:

- It is money borrowed for an **ultra vires** (or restricted) purpose, and this is known to the lender.
- The directors **exceed their borrowing powers** or have no powers to borrow.

However:

- In both cases the lender will probably be **able** to **enforce** the contract.
- If the contract is within the capacity of the company but beyond the delegated powers of the directors the company may **ratify** the **loan contract**.

Case law has determined that if a company has power to borrow, it also has power to **create charges** over the company's assets as **security** for the loan: *Re Patent File Co 1870.*

2 Debentures and loan capital

2.1 Loan capital

FAST FORWARD

Loan capital comprises all the longer term borrowing of a company. It is distinguished from share capital by the fact that, at some point, borrowing must be repaid. Share capital on the other hand is only returned to shareholders when the company is wound up.

A company's **loan capital** comprises all amounts which it borrows for the long-term, such as:

(a) Permanent overdrafts at the bank
(b) Unsecured loans, from a bank or other party
(c) Loans secured on assets, from a bank or other party

Companies often issue long-term loans as capital in the form of **debentures**.

2.2 Debentures

FAST FORWARD

A **debenture** is a document stating the terms on which a company has borrowed money. There are three main types.

- A **single debenture**
- **Debentures issued as a series** and usually registered
- **Debenture stock** subscribed to by a large number of lenders. Only this form requires a **debenture trust deed**, although the others may often incorporate one

Key term

A **debenture** is the written acknowledgement of a debt by a company normally containing provisions as to payment of interest and the terms of repayment of principal. A debenture may be secured on some or all of the assets of the company or its subsidiaries.

A debenture may create a **charge** over the company's assets as security for the loan (see Section 3). However a document relating to an unsecured loan is also a debenture in company law.

2.3 Types of debenture

A debenture is usually a formal legal document, often in printed form. Broadly, there are three main types.

(a) **A single debenture**

If, for example, a company obtains a secured loan or overdraft facility from its bank, the latter is likely to insist that the company seals the bank's standard form of debenture creating the charge and giving the bank various safeguards and powers.

(b) **Debentures issued as a series and usually registered**

Different lenders may provide different amounts on different dates. Although each transaction is a separate loan, the intention is that the lenders should rank equally *(pari passu)* in their right to repayment and in any security given to them. Each lender therefore receives a debenture in identical form in respect of his loan.

The debentures are transferable securities.

(c) **The issue of debenture stock subscribed to by a large number of lenders**

Only a public company may use this method to offer its debentures to the public and any such offer is a prospectus; if it seeks a listing on The Stock Exchange then the rules on listing particulars must be followed.

Each lender has a right to be **repaid** his **capital** at the **due time** (unless they are perpetual) and to receive **interest** on it until **repayment**. This form of borrowing is treated as a single loan 'stock' in which each debenture stockholder has a specified fraction (in money terms) which they or some previous holder contributed when the stock was issued. Debenture stock is transferable in multiples of, say, $1 or $10.

A company must maintain a **register of all debenture holders** and register an allotment within 2 months.

One advantage of debenture stock over debentures issued as single and indivisible loan transactions is that the holder of debenture stock can sell part of his holding, say $1,000 (nominal), out of a larger amount. Debenture stock must be created using a **debenture trust deed** though single and series debenture's may also use a debenture trust deed.

2.4 Debenture trust deed

Major elements of a debenture trust deed for debenture stock
The appointment usually of a trustee for prospective debenture stockholders. The trustee is usually a bank, insurance company or other institution but may be an individual.
The nominal amount of the debenture stock is defined, which is the maximum amount which may be raised then or later. The date or period of repayment is specified, as is the rate of interest and half-yearly interest payment dates.
If the debenture stock is secured **the deed creates a charge or charges** over the assets of the company.
The trustee is authorised to **enforce the security** in case of default and, in particular, to appoint a receiver with suitable powers of management.
The company enters into **various covenants**, for instance to keep its assets fully insured or to limit its total borrowings; breach is a default by the company.
There may be elaborate provisions for **transfer of stock** and **meetings** of debenture stockholders.

Advantages of a debenture trust deed for debenture stock
The **trustee** with appropriate powers can **intervene promptly** in case of default.
Security for the debenture stock in the form of charges over property can be **given to a single trustee**.
The **company** can **contact a representative of the debentureholders** with whom it can negotiate.
By calling a **meeting of debentureholders**, the trustee can consult them and obtain a decision binding on them all.
The **debentureholders** will be able to **enjoy the benefit of a legal mortgage** over the company's land.

2.5 Register of debentureholders

Company law does not specifically require a register of debentureholders be maintained. However, a company is normally required to maintain a register by the debenture or debenture trust deed when debentures are issued as a series or when debenture stock is issued.

When there is a register of debentureholders, the following regulations apply.

(a) The company is required by law to keep the **register** at its registered office, or at an **address** notified to the registrar: s 743.

(b) The register must be open to **inspection** by **any person** unless the constitution or trust deed provide otherwise. Any person may obtain a copy of the register or part of it for a fee. A holder of debentures issued under a trust deed may require the company (on payment) to supply them with a copy of the deed: s 749.

Under s 745 a company has **five days** to respond to an inspection request or seek exemption to do so from the court.

(c) The register should be **properly kept** in accordance with the requirements of the Companies Act.

2.6 Rights of debentureholders

The position of debentureholders is best described by comparison with that of shareholders. At first sight the two appear to have a great deal in common.

- Both **own transferable company securities** which are usually long-term investments in the company.
- The **issue procedure** is much the same. An offer of either shares or debentures to the public is a prospectus as defined by the Act.
- The **procedure** for **transfer** of registered shares and debentures is the same.

But there are significant differences.

Differences	Shareholder	Debentureholder
Role	Is a proprietor or owner of the company	Is a creditor of the company
Voting rights	May vote at general meetings	May not vote
Cost of investment	Shares may not be issued at a discount to nominal value	Debentures may be offered at a discount to nominal value
Return	Dividends are only paid • Out of distributable profits • When directors declare them	Interest must be paid when it is due
Redemption	Statutory restrictions on redeeming shares	No restriction on redeeming debentures
Liquidation	Shareholders are the last people to be paid in a winding up	Debentures must be paid back before shareholders are paid

From the investor's standpoint debenture stock is often **preferable to preference shares**. Although both yield a fixed income, debenture stock offers greater security.

2.6.1 Advantages and disadvantages of debentures (for the company)

Advantages	Disadvantages
Easily traded	May have to pay high interest rates to make them attractive
Terms clear and specific	Interest payments mandatory
Assets subject to a floating charge may be traded	Interest payments may upset shareholders if dividends fall
Popular due to guaranteed income	Debentureholder's remedies of liquidators or receivers may be disastrous for the company
Interest tax-deductible	Crystallisation of a floating charge can cause trading difficulties for a company
No restrictions on issue or purchase by a company	

Question — **Rights of shareholders and debentureholders**

Explain how the rights of the shareholders of a company differ from the rights of its debentureholders.

Answer

Rights of shareholders and debentureholders

Shareholders are members of the company. Debentureholders are creditors but not members of the company. Their relationships with the company differ in the following principal respects.

What governs the relationship

A company's relationship with its shareholders is governed by

(a) Its articles which operate as a contract between them and between the shareholders and each other, and

(b) The Companies Act

The relationship between a company and its debentureholders is regulated by:

(a) The terms of the trust deed or other formal document, and
(b) (Different) provisions of the Companies Act

The major practical differences are set out below.

Voting

As members of the company, shareholders have the right to attend and vote at meetings. Debentureholders have no such automatic rights; they may however have votes if the articles and deed allow.

Income

A shareholder, even if he holds preference shares on which fixed dividends are due on specific days, can only receive dividends out of distributable profits. In addition he cannot force the company to pay dividends: *Bond v Barrow Haematite Steel Co* 1902.

By contrast interest at the agreed rate must be paid on debentures even if that interest has to be paid out of capital.

Rights on securities

The Companies Act confers pre-emption rights on shareholders, entitling them to first call on any new shares which are to be issued.

Debentureholders have no right of objection to further loans and debentures being taken out, unless the trust deed sets out restrictions. However there is no statutory restriction on debentureholders having debentures redeemed or purchased by the company. By contrast there are detailed rules regulating redemption or purchase of a company's own shares.

Rights if aggrieved

Shareholders have the right to complain to the court if directors are allowing *ultra vires* transactions or acting in a manner unfairly prejudicial to their interests. Shareholders can, by simple majority, remove directors from the board.

Debentureholders may have rights under the trust deed if the company breaches the agreement. These include:

(a) The right to appoint a receiver, or
(b) The right to enforce charges and sell the property under the charge to realise their debts.

Their consent may also be required before the company deals with certain of its assets, when the debentureholders have secured their loan by means of a fixed charge over those assets.

Rights on liquidation

In liquidation debentureholders must be repaid in full before anything is distributed to shareholders.

3 Charges

FAST FORWARD

A charge over the assets of a company gives a creditor a **prior claim** over other creditors to payment of their debt out of these assets.

Charges may be either **fixed**, which attach to the relevant asset on creation, or **floating**, which attach on 'crystallisation'. For this reason it is not possible to identify the assets to which a **floating** charge relates (until **crystallisation**).

3.1 Definition

Key term

A **charge** is an encumbrance upon real or personal property granting the holder certain rights over that property. They are often used as security for a debt owed to the charge holder. The most common form of charge is by way of legal mortgage, used to secure the indebtedness of borrowers in house purchase transactions. In the case of companies, charges over assets are most frequently granted to persons who provide loan capital to the business.

A charge **secured** over a company's assets gives to the creditor (called the 'chargee') a prior claim (over other creditors) to payment of their debt out of those assets. Charges are of two kinds, fixed and floating.

3.2 Fixed charges

Key term

A **fixed charge** is a form of protection given to secured creditors relating to specific assets of a company. The charge grants the holder the right of enforcement against the identified asset (in the event of default in repayment or some other matter) so that the creditor may realise the asset to meet the debt owed. Fixed charges rank first in order of priority in liquidation.

Fixed (or specific) charges attach to the relevant asset as soon as the charge is created. By its nature a fixed charge is best suited to assets which the company is likely to retain for a long period. A mortgage is an example of a fixed charge.

If the company disposes of the charged asset it will either **repay the secured debt** out of the proceeds of sale so that the charge is discharged at the time of sale, or **pass the asset over to** the purchaser still subject to the charge.

3.3 Floating charges

Key term

A **floating charge** has been defined, in *Re Yorkshire Woolcombers Association Ltd 1903*, as:

(a) A charge on a class of assets of a company, present and future …

(b) Which class is, in the ordinary course of the company's business, changing from time to time and …

(c) Until the holders enforce the charge the company may carry on business and deal with the assets charged.

Floating charges do not attach to the relevant assets until the charge crystallises.

A floating charge is **not restricted** to assets such as **receivables** or **inventory**. A floating charge over 'the undertaking and assets' of a company (the most common type) applies to future as well as to current assets.

3.4 Identification of charges as fixed or floating

It is not always immediately apparent whether a charge is fixed or floating. Chargees often do not wish to identify a charge as being floating as it may get paid later than certain preferential debts in insolvency proceedings.

A charge contract may declare the charge as fixed, or fixed and floating, whether it is or not. **The label attached** by parties in this way is **not a conclusive statement of the charge's legal nature**.

The general rule is that a **charge over assets will not be registered as fixed if it envisages that the company will still be able to deal with the charged assets without reference to the chargee**.

> *R in Right of British Columbia v Federal Business Development Bank 1988*
>
> *The facts:* In this Canadian case the Bank had a charge over the company's entire property expressed as 'a fixed and specific mortgage and charge'. Another term allowed the company to continue making sales from stock in the ordinary course of business until notified in writing by the bank to stop doing so.
>
> *Decision:* The charge was created as a floating, not a fixed, charge.

However, the courts have found **exceptions** to the general rule concerning permission to deal.

(a) In *Re GE Tunbridge Ltd 1995* it was held that as the three criteria stated in the *Yorkshire Woolcombers* case applied. The charge over certain fixed assets was a floating charge even though the company was required to obtain the chargee's permission before dealing with the assets.

(b) In *Re Cimex Ltd 1994* the court decided that the charge in dispute was a fixed charge. The assets did not in the ordinary course of business change from time to time; this was despite the company being able to deal with the assets without the chargee's permission.

3.4.1 Charges over receivables

Charges expressed to be fixed which cover **present and future receivables** (book debts) are particularly tricky.

Again the general rule applies. If the company is allowed to deal with money collected from customers without notifying the chargee, the courts have decided that the charge is floating. If the money collected must be paid to the chargee, say in reduction of an overdraft, the courts have determined that the charge is fixed: *Siebe Gorman & Co Ltd v Barclays Bank Ltd 1979.*

In 2005 the House of Lords held in *Re Spectrum Plus* that there can be no fixed charge over a company's book debts.

3.5 Creating a floating charge

A **floating charge** is **often created by express words**. However no special form of words is essential. If a **company** gives to a chargee rights over its assets while **retaining freedom to deal with them in the ordinary course of business** until the charge crystallises, that will be a charge which 'floats'. The particular assets subject to a floating charge cannot be identified until the charge attaches by crystallisation.

3.6 Crystallisation of a floating charge

FAST FORWARD

> Floating charges **crystallise** or harden (convert into a fixed charge) on the happening of certain relevant events.

Key term

> **Crystallisation** of a floating charge occurs when it is converted into a fixed charge: that is, a fixed charge on the assets owned by the company at the time of crystallisation.

Events causing crystallisation
The **liquidation** of the company
Cessation of the company's **business**
Active intervention by the chargee, generally by way of appointing a receiver
If the **charge contract so provides**, when notice is given by the chargee that the charge is converted into a fixed charge (on whatever assets of the relevant class are owned by the company at the time of the giving of notice)
The **crystallisation** of **another floating charge** if it causes the company to cease business.

Floating charge contracts sometimes make provision for 'automatic crystallisation'. This is where the charge is to crystallise when a **specified event** – such as a breach of some term by the company – occurs, regardless of whether:

- The chargee learns of the event.
- The chargee wants to enforce the charge as a result of the event.

Such clauses have been accepted by the courts if they state that, on the event happening, the floating charge is converted to a fixed one. Clauses which provide only that a company is to cease to deal with charged assets on the occurrence of a particular event have been rejected.

3.7 Comparison of fixed and floating charges

FAST FORWARD

Floating charges rank **behind** a number of other creditors on liquidation, in particular preferential creditors such as employees.

A **fixed charge** is normally the more satisfactory form of security since it **confers immediate rights** over identified assets. A **floating charge** has some advantage in being applicable to **current assets which may be easier to realise** than long-term assets subject to a fixed charge. If for example a company becomes insolvent it may be easier to sell its inventory than its empty factory.

The principal disadvantages of floating charges
The **holder** of a floating charge **cannot be certain** until the charge crystallises which assets will form his security.
Even when a floating charge has crystallised over an identified pool of assets the **chargeholder** may find themself **postponed** to the claim of **other creditors** as follows. (a) A **judgement creditor or landlord** who has seized goods and sold them may retain the proceeds if received before the appointment of the debentureholder's receiver: s 183 IA. (b) **Preferential debts** such as wages may be paid out of assets subject to a floating charge unless there are other uncharged assets available for this purpose: ss 40 and 175 IA. (c) The **holder** of a **fixed charge** over the same assets will usually have priority over a floating charge on those assets even if that charge was created before the fixed charge (see below). (d) A creditor may have sold goods and delivered them to the company on condition that he is to retain legal ownership until he has been paid (a **Romalpa** clause).
A **floating charge** may become **invalid automatically** if the company creates the charge to secure an existing debt and goes into liquidation within a year thereafter (s 245 IA). The period is only six months with a fixed charge.

3.8 Priority of charges

FAST FORWARD

If more than one charge exists over the **same class of property** then legal rules must be applied to see which takes priority in the event the company goes into liquidation.

Different charges over the **same** property may be given to different creditors. It will be necessary in such cases to determine which party's claim has **priority**.

Illustration

If charges are created over the same property to secure a debt of $5,000 to X and $7,000 to Y and the property is sold yielding only $10,000, either X or Y is paid in full and the other receives only the balance remaining out of $10,000 realised from the security.

Priority of charges
Fixed charges rank according to the **order of their creation**. If two successive fixed charges over the same factory are created on 1 January and 1 February the earlier takes priority over the later one.
A floating charge created before a fixed charge will only take priority if, when the latter was created, the **fixed chargee** had **notice** of a clause in the floating charge that prevents a later prior charge.
A **fixed charge created before** a **floating one** has **priority**.
Two floating charges take priority according to the **time of creation**.

If a floating charge is created and a fixed charge over the same property is created later the fixed charge has priority. This is, unless the fixed chargeholder knew of the existing floating charge. The **fixed** charge ranks **first** since it attached to the property at the time of **creation** but the **floating** charge attaches at the time of **crystallisation**. Once a floating charge has crystallised it becomes a fixed charge and a fixed charge created subsequently ranks after it.

A floating chargeholder may seek to protect himself against losing his priority by including in the terms of his floating charge a prohibition against the company creating a fixed charge over the same property (sometimes called a **'negative pledge clause'**).

If the company **breaks that prohibition** the creditor to whom the fixed charge is given nonetheless obtains priority, unless at the time when his charge is created he has **actual** knowledge of the prohibition.

If a company sells a charged asset to a **third party** the following rules apply.

- A chargee with a fixed charge still has recourse to the property in the hands of the third party – the **charge** is **automatically** transferred with the property.
- Property only remains charged by a floating charge if the **third party** had **notice** of it when he acquired the property.

Exam focus point

You should be aware of what fixed and floating charges are and what the implications are of the differences between them.

Question

Registering charges

A floating charge is created on 1 January 20X1. A fixed charge over the same property is created on 1 April 20X1. Assuming both are registered within the prescribed time limits, which ranks first?

Answer

The fixed charge attaches to the asset on creation; the floating charge only attaches on crystallisation, and the effect of crystallisation is not retrospective. Therefore the fixed charge ranks first.

4 Registration of charges

FAST FORWARD

To be valid and enforceable, charges must be **registered** within **21 days** of creation by the Registrar.

Certain types of **charge** created by a company **should be registered** within **21 days** with the Registrar by either the company or a person interested in it (eg the debenture trustee). Charges securing a **debenture issue** and **floating charges** are **specifically registrable**.

Other charges that are registrable include charges on:

- Uncalled share capital or calls made but not paid
- Land or any interest in land, other than a charge for rent
- Receivables (book debts)
- Goodwill or any intellectual property
- Ships or aircraft or any share in a ship

4.1 The registration process

The **company is responsible for registering the charge** but the charge **may** also **be registered** as a result of an application **by another person** interested in the charge.

The Registrar should be sent **the instrument** by which the charge is created or evidenced. The Registrar also has to be sent **prescribed particulars of the charge**.

- The date when the charge was created
- The amount of the debt which it secures
- Short particulars of the property to which the charge applies
- The person entitled to it

The Registrar files the particulars in the companies 'charges' register and notes the date of delivery. They also issue a **certificate** which is **conclusive evidence** that the **charge had been duly registered**.

The 21-day period for registration runs from the **creation** of the **charge**, or the acquisition of property charged, and not from the making of the loan for which the charge is security. Creation of a charge is usually effected by **execution of a document**.

4.2 Rectification of register of changes

A mistake or omission in registered particulars can only be rectified by the court ordering an extension of the period for registration, and with the subsequent rectification of the register. The court will only make the order if the error or omission was accidental or if it is just equitable to do so.

4.3 Failure to deliver particulars

The duty to deliver particulars falls upon the **company** creating the charge and if no one delivers particulars within 21 days, the **company and its officers are liable to a fine**: s 860.

Non-delivery in the time period results in the **charge** being **void** against an administrator, liquidator or any creditor of a company: s 874.

Non-delivery of a charge means that the sum secured by it is **payable forthwith on demand**: s 874.

4.3.1 Late delivery of particulars

The rules governing late delivery are the **same** as governing registration of **further particulars**, that is, a **court order** is required for registration.

A charge can only be registered late if it does not prejudice the creditors or shareholders of the company. Therefore, a correctly registered fixed charge has priority over a fixed charge created earlier but registered after it if that charge is registered late s 873.

4.4 Register of charges

As you already know, every company is under an obligation to keep a copy of documents creating charges, and a register of charges, at its registered office or any other location permitted by the Secretary of State.

Question — **Registering more charges**

A company creates a charge over a property in favour of Margaret on 1 May 20X7. It creates a further charge of the same type in favour of Chris over the same property on 13 May 20X7. The company has Chris's charge registered on 25 May 20X7, and Margaret's charge on 29 May 20X7.

Whose charge ranks first, and why?

Answer

Margaret's charge would have taken precedence because it was created first, had it been registered within the allowed period of 21 days, up to 22 May. However it was not registered until 29 May, and Chris's charge was legitimately registered in the period between 22 and 29 May when Margaret's charge was void. The court would probably have allowed late registration of Margaret's charge but not at the expense of Chris's rights per s 873.

5 Debentureholders' remedies

5.1 Rights of unsecured debentureholders

FAST FORWARD

A debentureholder **without security** has the same rights as any other creditor.

Any debentureholder is a creditor of the company with the normal remedies of an unsecured creditor. He could:

- **Sue** the company for debt and seize its property if his judgement for debt is unsatisfied
- Present a petition to the court for the **compulsory liquidation** of the company
- Apply to the court for an **administration order**, that is, a temporary reprieve to try and rescue a company

Point to note

We shall look at liquidation and administration in Chapter 17.

5.2 Rights of secured debentureholders

FAST FORWARD

A **secured** debentureholder may enforce the security if the company defaults on payment of interest or repayment of capital. They may take possession of the asset subject to the charge and sell it or apply to the court for its transfer to their ownership by a foreclosure order. They may appoint a receiver or administrator of it. A floating chargeholder may place the company into administration.

A **secured** debentureholder (or the trustee of a debenture trust deed) may enforce the security. They may:

- Take **possession of the asset** subject to the charge if they have a fixed charge (if they have a floating charge they may only take possession if the contract allows).
- **Sell it** (provided the debenture is executed as a deed).
- Apply to the court for its **transfer** to their ownership by foreclosure order (rarely used and only available to a legal chargee).
- Appoint a **receiver** of it, provided an **administration order** is not in effect or (in the case of floating charge holders), appoint an administrator without needing to apply to the court, (see Chapter 17).

Exam focus point

The last part of a question on charges may well ask what debentureholders can do if a company defaults.

Chapter Roundup

- Companies have an **implied power** to borrow for purposes incidental to their trade or business.
- **Loan capital** comprises all the longer term borrowing of a company. It is distinguished from share capital by the fact that, at some point, borrowing must be repaid. Share capital on the other hand is only returned to shareholders when the company is wound up.
- A **debenture** is a document stating the terms on which a company has borrowed money. There are three main types.
  - A **single debenture**
  - **Debentures issued as a series** and usually registered
  - **Debenture stock** subscribed to by a large number of lenders. Only this form requires a **debenture trust deed**, although the others may often incorporate one
- A charge over the assets of a company gives a creditor a **prior claim** over other creditors to payment of their debt out of these assets.
- Charges may be either **fixed**, which attach to the relevant asset on creation, or **floating**, which attach on 'crystallisation'. For this reason it is not possible to identify the assets to which a **floating** charge relates (until **crystallisation**).
- Floating charges **crystallise** or harden (convert into a fixed charge) on the happening of certain relevant events.
- Floating charges rank **behind** a number of other creditors on liquidation, in particular preferential creditors such as employees.
- If more than one charge exists over the **same class of property** then legal rules must be applied to see which takes priority in the event the company goes into liquidation.
- To be valid and enforceable, charges must be **registered** within **21 days** of creation by the Registrar.
- A debentureholder **without security** has the same rights as any other creditor.
- A **secured** debentureholder may enforce the security if the company defaults on payment of interest or repayment of capital. They may take possession of the asset subject to the charge and sell it or apply to the court for its transfer to their ownership by a foreclosure order. They may appoint a receiver or administrator of it. A floating charge holder may place the company into administration.

Quick Quiz

1 Which of the following are correct statements about the relationship between a company's ordinary shares and its debentures?

A Debentures do not confer voting rights, whilst ordinary shares do.
B The company's duty is to pay interest on debentures, and to pay dividends on ordinary shares.
C Interest paid on debentures is deducted from pre-tax profits, dividends are paid from net profits.
D A debentureholder takes priority over a member in liquidation.

2 A fixed charge

A Cannot be an informal mortgage
B Can be a legal mortgage
C Can only attach to land, shares or book debts
D Cannot attach to land

3 What are the elements of the definition of a floating charge?

4 Company law requires a company to maintain a register of charges, but not a register of debentureholders.

True ☐

False ☐

5 In which of the following situations will crystallisation of a floating charge occur?

A Liquidation of the company
B Disposal by the company of the charged asset
C Cessation of the company's business
D After the giving of notice by the chargee if the contract so provides

6 Certain types of charges need to be registered within 28 days of creation.

True ☐

False ☐

7 What steps can a fixed debentureholder take to enforce their security? (Max 30 words)

Answers to Quick Quiz

1 A, C and D are correct. Whilst the company has a contractual duty to pay interest on debentures, there is no duty on it to pay dividends on shares. B is therefore incorrect.

2 B. A mortgage is an example of a fixed charge. It can extend to, for instance, plant and machinery as well as land.

3 The charge is:

(a) A charge on a class of assets, present and future
(b) Which class is in the ordinary course of the company's business changing from time to time
(c) Until the holders enforce the charge, the company may carry on business and deal with the assets charged

4 True. A register of charges must be kept, a register of debentureholders is not required to be kept by the Act.

5 A, C and D are true. As the charge does not attach to the asset until crystallisation, B is untrue.

6 False. Certain charges such as charges securing a debenture issue and floating charges need to be registered within 21 days.

7 Take possession of the asset subject to the charge
Sell it
Apply to the court for a transfer to his ownership
Appoint a receiver of it

Now try the question below from the Exam Question Bank

Number	Level	Marks	Time
Q15	Examination	10	18 mins

Capital maintenance and dividend law

14

Topic list	Syllabus reference
1 Capital maintenance	E3(a)
2 Reduction of share capital	E3(a)
3 Issuing shares at a premium or at a discount	E3(b)
4 Distributing dividends	E3(c)

Introduction

The capital which a limited company obtains from its members as consideration for their shares is sometimes called **'the creditors' buffer'**. No one can prevent an unsuccessful company from losing its capital by trading at a loss. However, whatever capital the company does have must be held for the payment of the company's debts and may not be returned to members except under procedures which safeguard the interest of creditors. That is the price which members of a limited company are required to pay for the protection of limited liability. This principle has been developed in a number of detailed applications.

- Capital may only be distributed to members under the formal procedure of a **reduction** of **share capital** or a **winding up** of the company.
- A **premium** obtained on the allotment of shares and profits used to redeem or purchase shares of the company are statutory reserves subject to the basic rules on capital.
- **Dividends** may only be paid out of distributable profits.

Study guide

		Intellectual level
E3	**Capital maintenance and dividend law**	
(a)	Explain the doctrine of capital maintenance and capital reduction	2
(b)	Examine the effect of issuing shares at either a discount, or at a premium	2
(c)	Explain the rules governing the distribution of dividends in both private and public companies	2

Exam guide

Capital maintenance can be a difficult area. The different components of this chapter could all be examined separately in a knowledge question, or as an application question on the liability of a shareholder who took shares at a discount to nominal value, as in the Pilot Paper.

1 Capital maintenance

FAST FORWARD

The rules which dictate how a company is to manage and maintain its capital exist to maintain the delicate balance between the **members' enjoyment of limited liability** and the **creditors' requirements that the company shall remain able to pay its debts**.

Key term

Capital maintenance is a fundamental principle of company law, that limited companies should not be allowed to make payments out of capital to the detriment of company creditors. Therefore, the Companies Act contains many examples of control upon capital payments. These include provisions restricting dividend payments, and capital reduction schemes.

Exam focus point

The rules affecting the possible threats to capital are complicated in certain areas. However, provided you know the rules, questions on capital maintenance tend to be straightforward.

2 Reduction of share capital

FAST FORWARD

Reduction of capital can be achieved by: **extinguishing/reducing liability on partly-paid shares; cancelling paid-up share capital**; or **paying off part of paid-up share capital**. Court confirmation is required for public companies. The court considers the interests of creditors and different classes of shareholder. There must be power in the articles and a special resolution.

A limited company is permitted without restriction to cancel **unissued shares** as that change does not alter its financial position.

If a limited company with a share capital wishes to **reduce** its **issued share capital** it may do if:

- It has **power** to do so in its articles. (if it does not have power in the articles, these may be amended by a **special resolution).**
- It passes a **special resolution**. (If the articles have been amended, this is another special resolution)
- It obtains **confirmation** of the reduction **from the court**

2.1 Solvency statement

A private company need not apply to the court if it supports its special resolution with a solvency statement. A **solvency statement** is a **declaration** by the directors, provided **15 days** in advance of the meeting where the special resolution is to be voted on. It states there is **no ground** to suspect the company is currently **unable** or will be **unlikely to be able** to pay its debts for the next **twelve months**. All possible liabilities must be taken into account and the statement should be in the prescribed form, naming all the directors.

2.2 Why reduce share capital?

A company may wish to reduce its capital for one or more of the following reasons.

- The company has suffered a **loss** in the **value** of its **assets** and it reduces its capital to reflect that fact.
- The company wishes to **extinguish** the **interests** of some members entirely.
- The capital reduction is part of a **complicated arrangement** of capital which may involve, for instance, replacing share capital with loan capital.

There are three basic methods of reducing share capital specified in s 641 of the Act.

Method	What happens	Effects
Extinguish or reduce liability on partly paid shares	Eg Company has nominal value \$1 shares 75c paid up. Either (a) reduce nominal value to 75c; or (b) reduce nominal value to a figure between 75c and \$1.	Company gives up claim for amount not paid up (nothing is **returned** to shareholders).
Pay off part of paid-up share capital out of surplus assets	Eg Company reduces nominal value of fully paid shares from \$1 to 70c and repays this amount to shareholders	Assets of company are reduced by 30c in \$.
Cancel paid-up share capital which has been lost or which is no longer represented by available assets.	Eg Company has \$1 nominal fully paid shares but net assets only worth 50c per share. Difference is a debit balance on reserves. Company reduces nominal value to 50c, and applies amount to write off debit balance	Company can resume dividend payments out of future profits without having to make good past losses.

2.3 Role of the court in reduction of share capital

When the court receives an application for reduction of capital its **first concern** is the effect of the reduction on the company's ability to pay its debts, that is, that the creditors are protected.

If the reduction is by extinguishing liability or paying off part of paid-up share capital, the court requires that **creditors** shall be **invited** by advertisement to state their objections (if any) to the reduction. Where paid-up share capital is cancelled, the court **may** require an invitation to creditors.

Normally the company persuades the court to dispense with advertising for creditors' objections (which can be commercially damaging to the company).

Two possible approaches are:

- To **pay off** all **creditors** before application is made to the court; or, if that is not practicable
- To produce to the court a **guarantee**, say from the company's bank, that its existing debts will be paid in full

The **second** concern of the court, where there is more than one class of share, is whether the reduction is fair in its effect on different classes of shareholder.

If the reduction is, **in the circumstances**, a **variation of class rights** the **consent** of the class must be obtained under the variation of class rights procedure.

Within each class of share it is usual to make a uniform reduction of every share by the same amount per share, though this is **not** obligatory.

The court may also be concerned that the **reduction should not confuse or mislead people who may deal with the company in future**. It may insist that the company add 'and reduced' to its name or publish explanations of the reduction.

2.3.1 Confirmation by the court

If the court is satisfied that the reduction is in order, it confirms the reduction by making an order to that effect. A **copy of the court order** and a **statement of capital**, approved by the court, to show the altered share capital is delivered to the Registrar who issues a certificate of registration.

Question

Reduction of share capital

What are the main methods for a public company to reduce its share capital? What procedures must it follow?

Answer

If a public company wishes to reduce its **issued** share capital it may do so provided that:

(a) It has power to do so in its articles.
(b) It passes a special resolution.
(c) It obtains confirmation of the reduction from the court: s 641.

Requirement (a) is simply a matter of procedure. Articles usually contain the necessary power. If not, the company in general meeting would first pass a special resolution to alter the articles appropriately. They would then proceed to pass a special resolution to reduce the capital.

There are three basic methods of reducing share capital under s 641:

(a) Extinguish or reduce liability on partly-paid shares

(b) Cancel paid-up share capital which has been lost or which is no longer represented by available assets

(c) Pay off part of the paid-up share capital out of surplus assets

Although these are the methods specified in s 641, they are not the only possibilities.

If method (a) or (b) is used (or is part of a more complex scheme to reduce capital) creditors must be invited to object, and their consent must be granted. An alternative is that they are paid off, which will allow the court to confirm the reduction.

It should be remembered that public companies are subject to a minimum capital requirement, currently of £50,000. This means that any public company wishing to reduce its capital below this figure will only be allowed to do so by the court if it re-registers as a private company, which is not subject to the minimum capital requirement. This situation is, relatively rare.

3 Issuing shares at a premium or at a discount

FAST FORWARD

In issuing shares, a company must fix a **price** which is **equal** to or **more than** the **nominal value of the shares**. It may not allot shares at a discount to the nominal value.

Every share has a **nominal value** and **may not be allotted at a discount** to that: s 580.

In allotting shares every company is required to obtain in money or money's worth; consideration of a value at least equal to the nominal value of the shares plus the whole of any premium. To issue shares **'at par'** is to obtain equal value, say, $1 for a $1 share.

Ooregum Gold Mining Co of India v Roper, 1892

The facts: Shares in the company, although nominally £1, were trading, at a market price 12.5p. In an honest attempt to refinance the company, new £1 preference shares were issued and credited with 75p already paid, so the purchasers of the shares were actually paying twice the market value of the ordinary shares. When, however, the company subsequently went into insolvent liquidation the holders of the new shares were required to pay a further 75p.

If shares are allotted at a discount on their nominal value the allottee (and subsequent owners of the shares) must nonetheless pay the **full nominal value** with **interest** at the appropriate rate. Any subsequent holder of such a share who knew of the underpayment must make good the shortfall: s 588.

Consideration for shares	
Partly-paid shares	The no-discount rule only requires that, in allotting its shares, a company shall not fix a price which is less than the nominal value of the shares. It may leave part of that price to be paid at some later time. Thus $1 shares may be issued partly-paid – 75c on allotment and 25c when called for or by instalment. The unpaid capital passes with the shares. If transferred, they are a debt payable by the holder at the time when payment is demanded.
Underwriting fees	A company may pay underwriting or other commission in respect of an issue of shares if so permitted by its Articles. This means that, if shares are issued at par the net amount received will be below par value. This is not a contravention of s 580 (prohibiting allotment of shares at a discount).
Bonus issue	The allotment of shares as a 'bonus issue' is for full consideration since reserves, which are shareholders' funds, are converted into fixed capital and are used to pay for the shares.
Money's worth	The price for the shares may be paid in **money** or **'money's worth'**, including goodwill and know-how: s 582. It need not be paid in cash and the company may agree to accept a **'non-cash' consideration** of sufficient value. For instance, a company may issue shares in payment of the price agreed in the purchase of a property.

3.1 Private companies

FAST FORWARD

Private companies may issue shares for **inadequate consideration** provided the directors are behaving reasonably and honestly.

A private company may allot shares for **inadequate consideration** by acceptance of goods or services at an over-value. This loophole has been allowed to exist because in some cases it is very much a matter of opinion whether an asset is or is not of a stated value.

The **courts** therefore have **refused** to overrule directors in their valuation of an asset acquired for shares if it appears **reasonable** and **honest**: *Re Wragg 1897*. However a blatant and unjustified overvaluation will be declared **invalid**.

3.2 Public companies

FAST FORWARD

There are **stringent rules** on consideration for shares in public companies.

More stringent rules apply to public companies.

(a) The company must, at the time of allotment, receive **at least one quarter of the nominal value** of the shares and the **whole** of any premium: s 586.

(b) Any non-cash consideration accepted must be independently valued (see below).

(c) **Non-cash consideration** may **not** be accepted as payment for shares if an undertaking contained in such consideration is to be, or may be, **performed more than five years after the allotment.** This relates to, say, a property or business in return for shares. To enforce the five year rule the law requires that:

  (i) At the time of the allotment the **allottee** must **undertake** to **perform** his side of the agreement within a specified period which must not exceed five years; if no such undertaking is given the **allottee** becomes **immediately liable** to pay cash for his shares as soon as they are allotted

  (ii) If the **allottee later fails** to **perform** his undertaking to transfer property at the due time he becomes liable to pay **cash** for his shares when he defaults

(d) An **undertaking to do work or perform services is not to be accepted as consideration**. A public company may, however, allot shares to discharge a debt in respect of services already rendered.

  If a public company does accept future services as consideration, the holder must pay the company their **nominal value** plus any **premium** treated as paid-up, and **interest** at 5% on any such amount.

(e) Within **two years of receiving its trading certificate**, a public company **may not receive a transfer of non-cash assets from a subscriber** to the memorandum. This is unless its value as consideration is less then 10% of the issued nominal share capital and it has been independently valued and agreed by an ordinary resolution.

3.2.1 Valuation of non-cash assets

When a public company allots shares for a non-cash consideration the company must usually obtain a **report on its value** from an independent valuer.

The valuation report must be made to the company within the six months before the allotment. On receiving the report the company must send a copy to the proposed allottee and later to the Registrar.

The independent valuation rule does not apply to an allotment of shares made in the course of a takeover bid.

3.3 Allotment of shares at a premium

FAST FORWARD

If shares are issued at a premium, the **excess** must be credited to a **share premium** account.

Key term

Share premium is the excess received, either in cash or other consideration, over the nominal value of the shares issued.

An established company may be able to obtain consideration for new shares in excess of their nominal value. The excess, called 'share premium', must be credited to a **share premium account**.

Exam focus point

The prohibition on offer of shares at a discount on **nominal** value is often confused with a company issuing shares at a price below **market** value (which is not, provided there is no discount below nominal value, prohibited).

If a company obtains non-cash consideration for its shares which exceeds the nominal value of the shares the excess should also be credited to the **share premium account**.

3.3.1 Example: Using a share premium account

If a company allots its $1 (nominal) shares for $1.50 in cash, $1 per share is credited to the share capital account, and 50c to the share premium account.

Illustration

We will use the above example to illustrate the effects of the transaction on the balance sheet. The company has issued 100 shares.

	Before share issue	*After share issue*
	$	$
Cash	100	250
Share capital	100	200
Share premium	–	50
	100	250

The general rule is that reduction of the share premium account is subject to the **same** restrictions as reduction of share capital. You should learn the fact that **a company cannot distribute any part of its share premium account as dividend**.

3.4 Uses of the share premium account

FAST FORWARD

Use of the share premium account is limited. It is most often used for **bonus issues**.

The permitted uses of share premium are to pay:

- **Fully paid shares under a bonus issue** since this operation merely converts one form of fixed capital into another
- **Issue expenses** and **commission** in respect of a **new share issue**

Question

Increasing a company's share capital

Explain the rule concerning issuing shares at a discount to their nominal value.

Answer

Shares may not be issued at a discount to their nominal value: s 580. However shares may be issued 'partly paid' with, for example, 75c of a $1 share paid up. The 25c balance remains a liability that the shareholder must pay when demanded.

4 Distributing dividends

FAST FORWARD

Various rules have been created to ensure that dividends are only paid out of **available profits**.

Key term

A **dividend** is an amount payable to shareholders from profits or other distributable reserves.

4.1 Power to declare dividends

A company may only pay dividends out of **profits available for the purpose.**

The power to declare a dividend is given by the articles which often include the following rules.

Rules related to the power to declare a dividend
The **company** in **general meeting** may declare dividends.
No dividend may exceed the **amount recommended** by the directors who have an implied power in their discretion to set aside profits as reserves.
The directors may declare such **interim dividends** as they consider justified.
Dividends are normally declared payable on the **paid up amount** of **share capital**. For example a $1 share which is fully paid will carry entitlement to twice as much dividend as a $1 share 50c paid.
A dividend may be paid **otherwise than in cash**.
Dividends may be paid by **cheque** or **warrant** sent through the post to the shareholder at his registered address. If shares are held jointly, payment of dividend is made to the first-named joint holder on the register.

Listed companies generally pay two dividends a year; an **interim dividend** based on interim profit figures, and a **final dividend** based on the annual accounts and approved at the AGM.

A **dividend becomes a debt only** when it is **declared** and **due for payment**. A shareholder is not entitled to a dividend unless it is declared in accordance with the procedure prescribed by the articles and the declared date for payment has arrived.

This is so even if the member holds **preference shares** carrying a priority entitlement to receive a specified amount of dividend on a specified date in the year. The directors may decide to withhold profits and cannot be compelled to recommend a dividend.

If the articles refer to 'payment' of dividends this means **payment in cash**. A power to pay dividends **in specie** (otherwise than in cash) is not implied but may be expressly created. **Scrip dividends** are dividends paid by the issue of additional shares.

Any provision of the articles for the declaration and payment of dividends is subject to the overriding rule that **no dividend may be paid except out of profits distributable by law**.

4.2 Distributable profit

FAST FORWARD

Distributable profits may be defined as 'accumulated realised profits ... less accumulated realised losses'. **'Accumulated'** means that any losses of previous years must be included in reckoning the current distributable surplus. **'Realised'** profits are determined in accordance with generally accepted accounting principles.

Key term

Profits available for distribution are accumulated realised profits (which have not been distributed or capitalised) less accumulated realised losses (which have not been previously written off in a reduction or reorganisation of capital).

The word **'accumulated'** requires that any **losses** of **previous years** must be included in reckoning the current distributable surplus.

A profit or loss is deemed to be **realised** if it is treated as realised in accordance with generally accepted accounting principles. Hence, financial reporting and accounting standards in issue, plus generally accepted accounting principles (GAAP), should be taken into account when determining realised profits and losses.

Depreciation must be treated as a **realised loss**, and debited against profit, in determining the amount of distributable profit remaining.

However, a **revalued asset** will have deprecation charged on its historical cost and the increase in the value in the asset. The Companies Act allows the depreciation provision on the valuation increase to be treated also as a realised profit.

Effectively there is a cancelling out, and at the end **only depreciation that relates to historical cost will affect dividends**.

Illustration

Suppose that an asset purchased for $20,000 has a 10-year life. Provision is made for depreciation on a straight line basis. This means the annual depreciation charge of $2,000 must be deducted in reckoning the company's realised profit less realised loss.

Suppose now that after five years the asset is revalued to $50,000 and in consequence the annual depreciation charge is raised to $10,000 (over each of the five remaining years of the asset's life).

The effect of the Act is that $8,000 of this amount may be reclassified as a realised profit. The net effect is that realised profits are reduced by only $2,000 in respect of depreciation, as before.

If, on a general revaluation of all fixed assets, it appears that there is a diminution in value of any one or more assets, then any related provision(s) need **not** be treated as a realised loss.

The Act states that if a company shows development expenditure as an asset in its accounts it must usually be treated as a realised loss in the year it occurs. However, it can be carried forward in special circumstances (generally taken to mean in accordance with accounting standards).

4.3 Dividends of public companies

FAST FORWARD

A public company may only make a distribution if its **net assets** are, at the time, **not less than the aggregate of its called-up share capital and undistributable reserves**. It may only pay a dividend which will leave its net assets at not less than that aggregate amount.

A public company may only make a distribution if its **net assets are**, at the time, **not less than the aggregate of its called-up share capital and undistributable reserves**. The dividend which it may pay is limited to such amount as will leave its net assets at not less than that aggregate amount: s 831.

Undistributable reserves in s 831 are defined as:

(a) **Share premium account**

(b) **Capital redemption reserve**

(c) Any **surplus** of **accumulated unrealised profits** over **accumulated unrealised losses** (known as a revaluation reserve). However, a deficit of accumulated unrealised profits compared with accumulated unrealised losses must be treated as a realised loss

(d) Any **reserve** which the company is **prohibited** from **distributing** by **statute** or by its constitution or any law.

Illustration

Suppose that a public company has an issued share capital (fully paid) of $800,000 and $200,000 on share premium account (which is an undistributable reserve). If its assets less liabilities are less than $1 million it may not pay a dividend. If however its net assets are say $1,250,000 it may pay a dividend but only of such amount as will leave net assets of $1 million or more, so its maximum permissible dividend is $250,000.

The dividend rules apply to every form of distribution of assets of the company to its members except the following:

- The **issue of bonus shares** whether fully or partly paid
- The **redemption** or **purchase** of the company's **shares** out of **capital** or **profits**
- A **reduction** of **share capital**
- A **distribution** of **assets** to members in a **winding up**

Exam focus point

You must appreciate how the rules relating to public companies in this area are more stringent than the rules for private companies.

Question

Distribution of profit

What are the main rules affecting a company's ability to distribute its profits as dividends?

Answer

Dividends may only be paid by a company out of profits available for the purpose. There is a detailed code of statutory rules which determines what are distributable profits. The profits which may be distributed as dividend are accumulated realised profits, so far as not previously utilised by distribution or capitalisation, less accumulated realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made.

The word 'accumulated' requires that any losses of previous years must be included in reckoning the current distributable surplus.

The word 'realised' presents more difficulties. It clearly prevents the distribution of an increase in the value of a retained asset resulting from revaluation. However, it does not prevent a company from transferring to profit and loss account, profit earned on an uncompleted contract, if it is in accordance with generally accepted accounting principles.

There is no mention here of realised profits and so it would seem that there is no statutory guidance on this point. Nevertheless, in view of the authority of accounting standards, it is unlikely that profits determined in accordance with accounting standards would be considered unrealised. A realised capital loss will reduce realised profits.

The above rules on distributable profits apply to all companies, private or public. A public company is subject to an additional rule which may diminish but cannot increase its distributable profit as determined under the above rules.

A public company may only make a distribution if its net assets are, at the time, not less than the aggregate of its called-up share capital and undistributable reserves. The dividend which it may pay is limited to such amount as will leave its net assets at not less than that aggregate amount.

4.4 Relevant accounts

FAST FORWARD

The profits available for distribution are generally determined from the **last annual accounts** to be prepared.

Whether a company has profits from which to pay a dividend is determined by reference to its **'relevant accounts'**, which are generally the last annual accounts to be prepared: s 836.

If the auditor has qualified their report on the accounts they must also state in writing whether, in their opinion, the subject matter of his qualification is **material** in determining whether the dividend may be paid. This statement must have been circulated to the members (for a private company) or considered at a general meeting (for a public company).

A company may produce **interim accounts** if the latest annual accounts do not disclose a sufficient distributable profit to cover the proposed dividend. It may also produce **initial accounts** if it proposes to pay a dividend during its first accounting reference period or before its first accounts are laid before the company in general meeting. These accounts may be unaudited, but they must suffice to permit a proper judgement to be made of amounts of any of the relevant items.

If a **public** company has to produce initial or interim accounts, which is unusual, they must be full accounts such as the company is required to produce as final accounts at the end of the year. They need not be audited. However the auditors must, in the case of initial accounts, satisfy themselves that the accounts have been 'properly prepared' to comply with the Act. A copy of any such accounts of a public company (with any auditors' statement) must be delivered to the Registrar for filing.

4.5 Infringement of dividend rules

FAST FORWARD

In certain situations the **directors** and **members** may be liable to make good to the company the amount of an **unlawful dividend**.

If a dividend is paid otherwise than out of distributable profits the company, the **directors and** the **shareholders** may be involved in making good the unlawful distribution.

The directors are held **responsible** since they either recommend to members in general meeting that a dividend should be declared or they declare interim dividends.

(a) **The directors are liable if they recommend or declare a dividend which they know is paid out of capital**.

(b) **The directors are liable if, without preparing any accounts, they declare or recommend a dividend which proves to be paid out of capital**. It is their duty to satisfy themselves that profits are available.

(c) **The directors are liable if they make some mistake of law or interpretation of the constitution which leads them to recommend or declare an unlawful dividend**. However in such cases the directors may well be entitled to relief as their acts were performed 'honestly and reasonably'.

The directors may however **honestly** rely on proper accounts which disclose an apparent distributable profit out of which the dividend can properly be paid. They are not liable if it later appears that the assumptions or estimates used in preparing the accounts, although reasonable at the time, were in fact unsound.

The position of members is as follows.

- A member may obtain an **injunction** to restrain a company from paying an unlawful dividend.
- Members voting in general meeting **cannot authorise** the payment of an unlawful dividend nor release the directors from their liability to pay it back.
- The company can **recover from members** an **unlawful dividend** if the **members knew** or had **reasonable grounds** to believe that it was unlawful, s847.
- If the directors have to make good to the company an unlawful dividend they may claim **indemnity from members** who at the time of receipt knew of the irregularity.
- Members knowingly receiving an unlawful dividend may **not bring an action** against the directors.

If an unlawful dividend is paid by **reason of error** in the **accounts** the company may be unable to claim against either the directors or the members. The company might then have a claim against its **auditors** if the undiscovered mistake was due to negligence on their part.

Re London & General Bank (No 2) 1895

The facts: The auditor had drawn the attention of the directors to the fact that certain loans to associated companies were likely to prove irrecoverable. The directors refused to make any provision for these potential losses. They persuaded the auditor to confine his comments in his audit report to the uninformative statement that the value of assets shown in the balance sheet 'is dependent on realisation'. A dividend was paid in reliance on the apparent profits shown in the accounts. The company went into liquidation and the liquidator claimed from the auditor compensation for loss of capital due to his failure to report clearly to members what he well knew affecting the reliability of the accounts.

Decision: The auditor has a duty to report what he knows of the true financial position: otherwise his audit is 'an idle farce'. He had failed in this duty and was liable.

Chapter Roundup

- The rules which dictate how a company is to manage and maintain its capital exist to maintain the delicate balance between the **members' enjoyment of limited liability** and the **creditors' requirements that the company shall remain able to pay its debts**.
- Reduction of capital can be achieved by: **extinguishing/reducing liability on partly-paid shares; cancelling paid-up share capital;** or **paying off part of paid up share capital**. Court confirmation is required for public companies. The court considers the interests of creditors and different classes of shareholder. There must be power in the articles and a special resolution.
- In issuing shares, a company must fix a **price** which is **equal** to or **more than** the **nominal value of the shares**. It may not allot shares at a discount to the nominal value.
- Private companies may issue shares for **inadequate consideration** provided the directors are behaving reasonably and honestly.
- There are **stringent rules** on consideration for shares in public companies.
- If shares are issued at a premium, the **excess** must be credited to a **share premium** account.
- Use of the share premium account is limited. It is most often used for **bonus issues**.
- Various rules have been created to ensure that dividends are only paid out of **available profits**.
- Distributable profits may be defined as 'accumulated realised profits ... less accumulated realised losses'. **'Accumulated'** means that any losses of previous years must be included in reckoning the current distributable surplus. **'Realised'** profits are determined in accordance with generally accepted accounting principles.
- A public company may only make a distribution if its **net assets** are, at the time, **not less than the aggregate of its called-up share capital and undistributable reserves**. It may only pay a dividend which will leave its net assets at not less than that aggregate amount.
- The profits available for distribution are generally determined from the **last annual accounts** to be prepared.
- In certain situations the **directors** and **members** may be liable to make good to the company the amount of an **unlawful dividend**.

Quick Quiz

1 Where application is made to the court for confirmation of a reduction in capital, the court may require that creditors should be invited by advertisement to state their objections. In which of the following ways can the need to advertise be avoided?

A Paying off all creditors before application to the court
B Producing a document signed by the directors stating the company's ability to pay its debts
C Producing a guarantee from the company's bank that its existing debts will be paid in full
D Renouncement by existing shareholders of their limited liability in relation to existing debts

2 A share premium account can be used for bonus issues of shares or issue costs for new share issues.

True ☐

False ☐

3 **Fill in the blanks** in the statements below.

Distributable profits may be defined as ……………….. ……..…. profits less ……………….. …………. losses.

4 If a company makes an unlawful dividend, who may be involved in making good the distribution?

A The company
B The directors
C The shareholders

5 Give four examples of undistributable reserves.

6 What normally are a company's relevant accounts in the context of payments of dividends?

Answers to Quick Quiz

1 A and C. The only guarantee that the courts will accept is from the company's bank.

2 True. Both are acceptable uses for the share premium account.

3 Distributable profits may be defined as **accumulated realised** profits less **accumulated realised** losses.

4 All three may be liable.

5 Share premium account

Capital redemption reserve

A surplus of accumulated unrealised profits over accumulated unrealised losses (revaluation reserve)

Any reserve which the company is prohibited from distributing by statute or by its constitution or any law.

6 The relevant accounts are the last accounts to have been prepared and laid in general meeting.

Now try the question below from the Exam Question Bank

Number	Level	Marks	Time
Q16	Examination	10	18 mins

PART F

Management, administration and regulation of companies

Company directors and other company officers

15

Topic list	Syllabus reference
1 The role of directors	F1(a)
2 Appointment of directors	F1(b)
3 Remuneration of directors	F1(b)
4 Vacation of office	F1(b)
5 Disqualification of directors	F1(b)
6 Powers of directors	F1(c)
7 Powers of the managing director	F1(c)
8 Powers of an individual director	F1(c)
9 Duties of directors	F1(d), F1(e)
10 The company secretary	F2(a)
11 The company auditor	F2(b)

Introduction

In this chapter we turn our attention to the **appointment** and **removal**, and the **powers and duties, of the directors**.

The important principle to grasp is that the **extent of directors' powers is defined by the articles**.

If **shareholders** do not approve of the directors' acts they must either **remove them** under s 168 or **alter the articles** to regulate their future conduct. However, they **cannot** simply **take over** the functions of the directors.

In essence, the directors act as **agents of the company**. This ties in with the **agency** part of your law studies also discussed in connection with partnerships. The different types of authority a director can have (implied and actual) are important in this area.

We also consider the **duties** of directors under statute and **remedies for the breach of such duties**.

Statute also imposes some duties on directors, specifically concerning openness when transacting with the company.

Finally, we look at the duties and powers of the **company secretary** and **auditor**.

Study guide

		Intellectual level
F	**Management, administration and regulation of companies**	
1	**Company directors**	
(a)	Explain the role of directors in the operation of a company	2
(b)	Discuss the ways in which directors are appointed, can lose their office or be subject to a disqualification order	2
(c)	Distinguish between the powers of the board of directors, the managing director and individual directors to bind their company	2
(d)	Explain the duties that directors owe to their companies	2
(e)	Demonstrate an understanding of the way in which statute law has attempted to control directors	2
2	**Other company officers**	
(a)	Discuss the appointment procedure relating to, and the duties and powers of, a company secretary	2
(b)	Discuss the appointment procedure relating to, and the duties and powers of, company auditors	2

Exam guide

The relationship between members of a company and their directors could be examined in a knowledge based or scenario question. The detailed rules regarding directors and other company officers are all highly examinable.

1 The role of directors

FAST FORWARD

Any person who occupies the position of director is treated as such, the test being one of **function**.

Key term

A **director** is a person who is responsible for the overall direction of the company's affairs. In company law, director means any person occupying the position of director, by whatever name called.

Any person who occupies the position of director is treated as such. The test is one of **function**. The directors' function is to take part in **making decisions** by **attending meetings** of the board of directors. Anyone who does that is a director whatever they may be called.

A person who is given the title of director, such as 'sales director' or 'director of research', to give them status in the company structure is not a director in company law. This is unless by virtue of their appointment they are a **member** of the **board** of **directors**, or they carry out functions that would be properly discharged only by a director. Anyone who is held out by a company as a director, and who acts as a director although not validly appointed as one, is known as a **de facto** director.

1.1 Shadow directors

A person might seek to **avoid the legal responsibilities of being a director** by avoiding appointment as such but using his power, say as a major shareholder, to manipulate the acknowledged board of directors.

Company law seeks to prevent this abuse by extending several statutory rules to **shadow directors**. Shadow directors are directors for legal purposes if the board of directors are accustomed to act in **accordance with their directions** and **instructions**.

This rule does not apply to professional advisers merely acting in that capacity.

1.2 Alternate directors

A director may, if the articles permit, appoint an **alternate director** to attend and vote for them at board meetings which they are unable to attend. Such an alternate may be another director, in which case they have the vote of the absentee as well as their own. More usually they are an outsider. Company articles could make specific provisions for this situation.

1.3 Executive directors

Key term

An **executive director** is a director who performs a specific role in a company under a **service contract** which requires a regular, possibly daily, involvement in management.

A director may also be an **employee** of his company. Since the company is also his **employer** there is a potential conflict of interest which in principle a director is required to avoid.

To allow an individual to be **both a director and employee** the articles usually make express provision for it, but prohibit the director from voting at a board meeting on the terms of their own employment.

Directors who have additional management duties as employees may be distinguished by **special titles**, such as 'Finance Director'. However (except in the case of a managing director) **any such title does not affect their personal legal position**. They have two distinct positions as:

- A member of the board of directors; and
- A manager with management responsibilities as an **employee**

1.4 Non-executive directors

Key term

A **non-executive director** does not have a function to perform in a company's management but is involved in its governance.

In **listed companies**, corporate governance codes state that boards of directors are more likely to be fully effective if they comprise both **executive directors** and strong, independent **non-executive directors**. We shall look at this further in Chapter 18.

The main tasks of the NEDs are as follows:

- **Contribute** an **independent view** to the board's deliberations
- **Help the board provide** the company with **effective leadership**
- **Ensure** the **continuing effectiveness** of the **executive directors** and management
- **Ensure high standards** of **financial probity** on the part of the company

Non-executive and shadow directors are subject to the same duties as executive directors. Duties are discussed in Section 9.

1.5 The managing director

Key term

A **managing director** is one of the directors of the company appointed to carry out overall day-to-day management functions.

If the articles provide for it the board may appoint one or more directors to be **managing directors**. A managing director ('MD') does have a special position and has wider apparent powers than any director who is not appointed an MD.

Exam focus point

The June 2008 exam included a question that required an explanation of three types of director.

1.6 Number of directors

Every company must have at least **one** director and for a **public** company the minimum is **two**. There is no statutory maximum in the UK but the articles usually impose a limit. At least one director must be a **natural person**, not a body corporate.

A **company** may be a director. In that case the director company sends an individual to attend board meetings as its representative.

1.7 The board of directors

Companies are run by the directors collectively, in a **board of directors**.

Key term

The **board of directors** is the elected representative of the shareholders acting collectively in the management of a company's affairs.

One of the basic principles of company law is that the **powers** which are delegated to the directors under the articles are given to them as a **collective body.**

The **board meeting** is the **proper place for the exercise of the powers,** unless they have been validly passed on, or 'sub-delegated', to committees or individual directors.

2 Appointment of directors

FAST FORWARD

The method of appointing directors, along with their rotation and co-option is **controlled** by the **articles.**

A director may be **appointed expressly**, in which case they are known as a *de jure* director.

Where a person acts as a director without actually being appointed as such (a *de facto* or **shadow director**) they incur the obligations and have some of the powers of a proper director. In addition, a shadow director is subject to many of the duties imposed on directors.

2.1 Appointment of first directors

The application for registration delivered to the Registrar to form a company includes particulars of the first directors, with their consents. On the formation of the company those persons become the first directors.

2.2 Appointment of subsequent directors

Once a company has been formed further directors can be appointed, either to **replace** existing directors or as **additional** directors.

Appointment of further directors is carried out **as the articles provide**. Most company articles allow for the appointment of directors:

- By **ordinary resolution** of the shareholders, and
- By a **decision** of the directors.

However the articles do not have to follow these provisions and may impose **different methods** on the company.

When the appointment of directors is proposed at a general meeting of a public company a **separate** resolution should be proposed for the election of **each director**. However the rule may be waived if a resolution to that effect is first carried without any vote being given against it.

2.3 Publicity

In addition to giving notice of the first directors, every company must within **14 days** give **notice** to the **Registrar** of any change among its directors. This includes any changes to the register of directors' residential addresses.

2.4 Age limit

The **minimum age** limit for a director is **16** and, unless the articles provide otherwise, there is no upper limit.

3 Remuneration of directors

FAST FORWARD

Directors are entitled to **fees** and **expenses** as directors as per the articles, and **emoluments** (and compensation for loss of office) as per their service contracts (which can be inspected by members). Some details are published in the directors' remuneration report along with accounts.

Details of directors' remuneration is usually contained within their service contract (see Section 4 Chapter 10). This is a contract where the director agrees to personally perform services for the company.

3.1 Directors' expenses

Most articles state that directors are entitled to **reimbursement** of **reasonable expenses** incurred whilst carrying out their duties or functions as directors.

In addition, most directors have **written service contracts** setting out their entitlement to emoluments and expenses. Where service contracts **guarantee employment** for longer than **two years** then an **ordinary resolution** must be passed by the members of the company that the contract is with.

3.2 Compensation for loss of office

Any director may receive **non-contractual** compensation for loss of office paid to him voluntarily. Any such compensation is lawful **only if** approved by members of the company in general meeting after proper disclosure has been made to all members, whether voting or not.

This only applies to uncovenanted payments; approval is not required where the company is contractually bound to make the payment.

Compensation paid to directors for loss of office is distinguished from any payments made to directors **as employees**. For example, to settle claims arising from the premature termination of the service agreements. These are contractual payments which do not require approval in general meeting.

3.3 Directors' remuneration report

Quoted companies are required to include a **directors' remuneration report** as part of their annual report, part of which is subject to audit. The report must cover:

- The details of each **individual directors' remuneration package**
- The company's **remuneration policy**
- The **role** of the **board** and **remuneration committee** in deciding the **remuneration** of **directors**

Under s 421(3), it is the duty of the directors (including those who were a director in the preceding five years) to provide any information about themselves that is necessary to produce this report.

Quoted companies are required to allow a vote by members on the directors' remuneration report. The vote is purely advisory and does not mean the remuneration should change if the resolution is not passed. A negative vote would be a strong signal to the directors that the members are unhappy with remuneration levels.

Items not subject to audit

- Consideration by the directors (remuneration committee) of matters relating to directors' remuneration
- Statement of company's policy on directors' remuneration
- Performance graph (share performance)
- Directors' service contracts (dates, unexpired length, compensation payable for early termination)

Items subject to audit

- Salary/fees payable to each director
- Bonuses paid/to be paid
- Expenses
- Compensation for loss of office paid
- Any benefits received
- Share options and long term incentive schemes – performance criteria and conditions
- Pensions
- Excess retirement benefits
- Compensation to past directors
- Sums paid to third parties in respect of a director's services

3.4 Inspection of directors' service agreements

A company must make available for inspection by members a copy or particulars of **contracts of employment** between the company or a subsidiary with a director of the company. Such contracts must cover all services that a director may provide including services outside the role of a director, and those made by a third party in respect of services that a director is contracted to perform.

Contracts must be **retained** for **one year** after expiry and must be available either at the **registered office**, or any other location permitted by the Secretary of State.

Prescribed particulars of **directors' emoluments** must be given in the accounts and also particulars of any **compensation for loss of office** and directors' **pensions**.

4 Vacation of office

FAST FORWARD

A director may vacate office as director due to: **resignation**; **not going** for **re-election**; **death**; **dissolution** of the company; **removal**; **disqualification**.

A director may leave office in the following ways.

- **Resignation**
- Not **offering themselves for re-election** when their term of office ends
- **Death**
- **Dissolution of the company**
- Being **removed** from office
- Being **disqualified**

A form should be filed with the Registrar whenever and however a director vacates office.

4.1 Retirement and re-election of directors

The model articles for public companies provide the following rules for the retirement and re-election of all directors except the managing director ('rotation').

(a) Every year **half** (or the number nearest to half) shall **retire**; at the first AGM of the company they all retire.

(b) **Retiring directors** are **eligible** for **re-election**.

(c) Those retiring shall be those **in office longest** since their last election.

(d) When calculating which directors are required to retire by rotation, directors who were **appointed to the board** during the year (and therefore are obliged to stand for re-election) and those **retiring** and **not seeking re-election** are **not included** in the calculation.

Question — Rotation of directors

The board of Teddy plc has the following directors at the start of its AGM on 31 December 20X7.

	Age	*When last re-elected*
Mrs Clare	42	31 December 20X4
Mr Paul	64	31 December 20X5
Mr Bob	27	31 December 20X5
Mr Nick	30	31 December 20X5
Miss Alison	60	31 December 20X6
Mr Maurice	38	31 December 20X6
Mrs Pippa	34	31 December 20X6
Mr Gordon	43	2 May 20X7
Mrs Helen	41	2 May 20X7

At a board meeting on 2 May 20X7 Mr Gordon and Mrs Helen were appointed to fill casual vacancies and Mrs Clare was appointed managing director.

Which directors would be due for re-election at the AGM on 31 December 20X7?

Answer

Mr Gordon and Mrs Helen must stand for re-election since they have been appointed during the year.

Calculation of who is to retire by rotation excludes Mr Gordon, Mrs Helen and Mrs Clare (as Managing Director), thus leaving six directors. Three of those must therefore retire, and as Mr Paul, Mr Bob and Mr Nick have been in office the longest, it must be them.

4.2 Removal of directors

In addition to provisions in the articles for removal of directors, a director may be removed from office by **ordinary** resolution at a meeting of which **special notice** to the company has been given by the person proposing it: s 168.

On receipt of the special notice the company must send a copy to the director who may require that a **memorandum of reasonable length** shall be issued to members. They also have the **right to address the meeting** at which the resolution is considered.

The articles and the service contract of the director **cannot override the statutory power**. However, the articles can **permit dismissal without the statutory formalities** being observed, for example dismissal by a resolution of the board of directors.

The power to remove a director is **limited** in its effect in four ways.

Restrictions on power to remove directors	
Shareholding qualification to call a meeting	In order to propose a resolution to remove a director, the shareholder(s) involved must call a general meeting. To do this they must hold: • Either, 10% of the paid up share capital • Or, 10% of the voting rights where the company does not have shares
Shareholding to request a resolution	Where a meeting is already convened, 100 members holding an average £100 of share capital each may request a resolution to remove a director: s 338.
Weighted voting rights	A director who is also a member may have weighted voting rights given to them under the constitution for such an eventuality, so that they can automatically defeat any motion to remove them as a director: *Bushell v Faith 1970*
Class right agreement	It is possible to draft a shareholder agreement stating that a member holding each class of share must be present at a general meeting to constitute quorum. If so, a member holding shares of a certain class could prevent a director being removed by not attending the meeting.

Exam focus point

The courts have stressed that the s 168 power of members to remove directors is an important right, but you should remember the ways in which members' intentions might be frustrated.

The dismissal of a director may also entail payment of a **substantial sum** to settle their claim for breach of contract if they have a service contract. Under s 168(5), no resolution may deprive a removed director of any compensation or damages related to their termination to which they are entitled to.

Southern Foundries (1926) Ltd v Shirlaw 1940

The facts: In 1933 S entered into a written agreement to serve the company as managing director for ten years. In 1936 F Co gained control of the company and used their votes to alter its articles to confer on F Co power to remove any director from office. In 1937 F Co exercised the power by removing S from his directorship and thereby terminated his appointment as managing director (which he could only hold so long as he was a director).

Decision: The alteration of the articles was not a breach of the service agreement but the exercise of the power was a breach of the service agreement for which the company was liable.

Question

Resolution for removal of director

A company has three members who are also directors. Each holds 100 shares. Normally the shares carry one vote each, but the articles state that on a resolution for a director's removal, the director to be removed should have 3 votes per share. On a resolution for the removal of Jeremy, a director, Jeremy casts 300 votes against the resolution and the other members cast 200 votes for the resolution. Has Jeremy validly defeated the resolution?

Answer

Yes. This was confirmed in a case called *Bushell v Faith 1970.*

5 Disqualification of directors

FAST FORWARD

Directors may be required to vacate office because they have been disqualified on grounds dictated by the articles. Directors **may** be disqualified from a wider range of company involvements under the Company Directors Disqualification Act 1986 (CDDA).

A person cannot be appointed a director or continue in office if he is or becomes **disqualified** under the articles or statutory rules as explained below. **The articles** often embody the statutory grounds of disqualification and add some optional extra grounds. Public company model articles provide that a director must vacate office if:

(a) They are **disqualified** by the **Act** or any rule of law.

(b) They become **bankrupt** or enter into an arrangement with creditors.

(c) They become of **unsound mind**.

(d) They **resign** by notice in writing.

(e) They are **absent** for a period of **three consecutive months** from board meetings held during that period, without obtaining leave of absence **and** the other directors resolve that they shall on that account vacate office.

Unless the court approves it, an **undischarged bankrupt** cannot act as a director nor be concerned directly or indirectly in the management of a company. If they do continue to act, they become personally liable for the company's relevant debts.

5.1 Disqualification under statute

The **Company Directors Disqualification Act 1986** (CDDA 1986) provides that a **court may** formally **disqualify a person from being a director**, or in any way directly or indirectly being concerned or taking part in the promotion, formation or management of a company: s 1.

Therefore, the terms of the disqualification order are very wide, and include acting as a consultant to a company. The Act, despite its title, is not limited to the disqualification of people who have been directors. **Any person** may be disqualified if they fall within the appropriate grounds. These are discussed later in the chapter, in the context of directors' duties.

In addition to the grounds of disqualification described above, the articles may provide that **a director shall automatically vacate office** if they are **absent** from **board meetings** (without obtaining the leave of the board) for a **specified period** (three months is usual). The effect of this disqualification depends on the words used.

- If the articles refer merely to 'absence' this includes involuntary absence due to illness.
- The words 'if they shall absent himself' restrict the disqualification to periods of voluntary absence.

The period of **three months** is reckoned to begin from the **last meeting** which the absent director did attend. The normal procedure is that a director who foresees a period of absence applies for leave of absence at the last board meeting which they attend; the leave granted is duly minuted. They are not then absent 'without leave' during the period.

If they fail to obtain leave but later offer a reasonable explanation the other directors may let the matter drop by simply not resolving that they shall vacate office. The general intention of the rule is to **impose a sanction against slackness**; a director has a duty to attend board meetings when they are able to do so.

Question — Disqualification of directors

Which of the following are grounds provided for a director being compelled to leave office?

A Becoming bankrupt
B Entering into an arrangement with personal creditors
C Becoming of unsound mind
D Resigning by notice in writing
E Being absent from board meetings for six consecutive months without obtaining leave of absence

Answer

All of them.

Question

The articles of Robert Ltd provide that if a director should 'absent himself' for a period exceeding three months from board meetings, the director shall automatically vacate office. Miles, a director, obtains a twelve month leave of absence to go abroad. Whilst abroad, he contracts a rare illness; on his return he is rushed to hospital and remains there for nine months. On the day of his release, there is a board meeting which he does not attend, and he resolves not to attend board meetings again. After a further two months he has a relapse and dies a fortnight later. At what point does he cease to be a director?

A After three months of his holiday
B After three months of hospitalisation
C At the point where he decides not to attend board meetings again
D When he dies

Answer

D The board can grant leave of absence, and 'absenting himself' does not include forced hospitalisation. The period of three months **begins** on his release from hospital, and has not been completed when he dies.

5.2 Grounds for disqualification of directors

FAST FORWARD

Directors may be **disqualified** from acting as directors or being involved in the management of companies in a number of circumstances. They must be disqualified if the company is insolvent, and the director is found to be unfit to be concerned with management of a company.

Under the CDDA 1986 the court **may** make a disqualification order on any of the following grounds.

(a) **Where a person is convicted of an indictable offence in connection with the promotion, formation, management or liquidation of a company or with the receivership or management of a company's property** (s 2).

An indictable offence is an offence which may be tried at a Crown Court; it is therefore a serious offence. It need not actually have been tried on indictment but if it was the maximum period for which the court can disqualify is 15 years, compared with only five years if the offence was dealt with summarily (at the Magistrates' Court).

(b) **Where it appears that a person has been persistently in default in relation to provisions of company legislation**.

This legislation requires any return, account or other document to be filed with, delivered or sent or notice of any matter to be given to the Registrar (s 3). Three defaults in five years are conclusive evidence of persistent default. The maximum period of disqualification under this section is five years.

(c) **Where it appears that a person has been guilty of fraudulent trading**. This is carrying on business with intent to defraud creditors or for any fraudulent purpose whether or not the company has been, or is in the course of being, wound-up, (see Chapter 19).

The person does not actually have to have been convicted of fraudulent trading. The legislation also applies to anyone who has otherwise been guilty of any fraud in relation to the company or of any breach of their duty as an officer etc (s 4). The maximum period of disqualification under this section is 15 years.

(d) **Where the Secretary of State acting on a report made by the inspectors or from information or documents obtained under the Companies Act, applies to the court for an order believing it to be expedient in the public interest.**

If the court is satisfied that the person's conduct in relation to the company makes that person unfit to be concerned in the management of a company, then it may make a disqualification order (s 8). Again the maximum is 15 years.

(e) **Where a director was involved in certain competition violations**. Maximum – 15 years.

(f) **Where a director of an insolvent company has participated in wrongful trading (s 10)** (see Chapter 19). Maximum – 15 years.

The court **must** make an order where it is satisfied that the following apply:

(a) A person has been a director of a company which has at any time become **insolvent** (whether while they were a director or subsequently).

(b) Their conduct as a director of that company makes them **unfit** to be **concerned** in the **management** of a company. The courts may also take into account their conduct as a director of other companies, whether or not these other companies are insolvent. Directors can be disqualified under this section even if they take no active part in the running of the business.

In such cases the **minimum** period of disqualification is two years.

Illustration

Offences for which directors have been disqualified include the following.

(a) **Insider dealing**: *R v Goodman 1993*

(b) **Failure** to **keep proper accounting records**: *Re Firedart Ltd, Official Receiver v Fairall 1994*

(c) **Failure to read the company's accounts**: *Re Continental Assurance Co of London plc 1996*

(d) **Loans** to another company for the purposes of purchasing its own shares with **no grounds for believing the money would be repaid**: *Re Continental Assurance Co of London plc 1996*

(e) **Loans** to associated companies on **uncommercial terms** to the detriment of creditors: *Re Greymoat Ltd 1997*

5.3 Disqualification periods

In *Re Sevenoaks Stationers (Retail) Ltd 1991* the Court of Appeal laid down certain 'disqualification brackets'. The appropriate period of disqualification which should be imposed was a **minimum of two to five years** if the conduct was not very serious, **six to ten years** if the conduct was serious but did not merit the maximum penalty, and **over ten years** only in particularly serious cases.

Disqualification as a director need not mean disqualification from all involvement in management: (*Re Griffiths 1997),* and it may mean that the director can continue to act as an **unpaid director** (*Re Barings plc 1998*), but only if the court gives leave to act.

5.3.1 Mitigation of disqualification

Examples of circumstances which have led the court to imposing a lower period of disqualification include:

- **Lack of dishonesty**: *Re Burnham Marketing Services Ltd 1993*
- **Loss of director's own money** in the company: *Re GSAR Realisations Ltd 1993*
- **Absence of personal gain**, for example excessive remuneration: *Re GSAR Realisations Ltd 1993*
- **Efforts to mitigate** the situation: *Re Burnham Marketing Services Ltd 1993*
- **Likelihood of re-offending**: *Re Grayan Building Services Ltd 1995*

- **Proceedings hanging over director** for a long time: *Re Aldermanbury Trust 1993*

5.4 Procedures for disqualification

Administrators, receivers and liquidators all have a statutory duty to report directors where they believe the conditions for a disqualification order have been satisfied.

The Secretary of State then decides whether to apply to the court for an order, but if they do decide to apply they must do so within two years of the date on which the company became insolvent.

Question

Disqualification

In what circumstances can a court make a disqualification order against a director of a company?

Answer

The provisions for disqualification of directors are contained in the Company Directors Disqualification Act 1986. A court may, by order, disqualify a person from being a director, liquidator, administrator, receiver or manager of a company, and from being concerned in the promotion or management of any company.

The order may be made in any one of the following circumstances.

(a) The director concerned is convicted of an indictable offence in connection with a company.

(b) The director concerned has been persistently in default in relation to company law requirements requiring the delivery to the Registrar of annual accounts, the annual return and other documents. A previous decision of a court on three previous occasions in five years that the person concerned has been in default in compliance with these requirements is conclusive evidence of 'persistent' default.

(c) The director concerned has been guilty of fraudulent trading.

(d) The Secretary of State applies for disqualification in the public interest. This would arise from an investigation by Government inspectors or documents obtained under the Companies Act.

(e) The director has been found to be in breach of certain aspects of competition law.

(f) The director has participated in wrongful trading in insolvency.

In general, disqualification may be ordered for up to 15 years. But the maximum is 5 years in case (b) above or when the order is made by a magistrates' court. A person subject to disqualification may apply to the court for remission of the order.

Bankruptcy

An undischarged bankrupt may not, without leave of the court, act as a director of a company or be concerned in the management or promotion of a company.

Here the disqualification is the automatic result of the bankruptcy order made against him by the court.

6 Powers of directors

FAST FORWARD

The **powers** of the directors are **defined** by the **articles**.

The powers of the directors are **defined by the articles**. The directors are usually authorised 'to manage the company's business' and 'to exercise all the powers of the company for any purpose connected with the company's business'.

Therefore they may take **any decision which is within the capacity** of the company **unless** either **the Act** or **the articles** themselves **require** that the **decision shall be taken by the members in general meeting**.

6.1 Restrictions on directors' powers

FAST FORWARD

Directors' powers may be restricted by statute or by the articles. The directors have a duty to exercise their powers in what they honestly believe to be the **best interests** of the company and for the **purposes** for which the powers are given.

6.1.1 Statutory restrictions

Many transactions, such as an alteration of the articles or a reduction of capital, must by law be effected by passing a **special resolution**. If the directors propose such changes they must secure the passing of the appropriate resolution by shareholders in a general meeting.

6.1.2 Restrictions imposed by articles

As an example, the articles often set a maximum amount which the directors may borrow. If the directors wish to exceed that limit, they should **seek authority** from a **general meeting**.

When the directors clearly have the necessary power, their decision may be challenged if they exercise the power in the wrong way. They must exercise their powers:

- In what they **honestly believe to be the interests of the company:** *Re Smith & Fawcett Ltd 1942*
- For a **proper purpose**, being the purpose for which the power is given: *Bamford v Bamford 1969.*

6.1.3 Members' control of directors

There is a **division of power** between the board of directors who manage the business and the members who as owners take the major policy decisions at general meetings. How, then, do the owners seek to 'control' the people in charge of their property?

- The members **appoint** the directors and may **remove** them from office under s 168.
- The members can, by **altering the articles** (special resolution needed), re-allocate powers between the board and the general meeting.
- Articles may allow the members to pass a **special resolution ordering** the **directors to act** (or **refrain from acting**) in a **particular way**. Such special resolutions cannot invalidate anything the directors have already done.

Remember **directors are not agents of the members.** They cannot be instructed by the members as to how they should exercise their powers. **The directors' powers are derived from the company as a whole** and are to be exercised by the directors as they think best in the **interests of the company**.

6.1.4 Control by the law

Certain powers must be exercised **'for the proper purpose'** and all powers must be exercised ***bona fide*** **for the benefit of the company**. Failure by the directors to comply with these rules will result in the **court setting aside their powers** unless the shareholders **ratify** the directors' actions by **ordinary resolution** (50 % majority).

7 Powers of the managing director

FAST FORWARD

One or more directors may be appointed by the board as **managing director**. The managing director has **apparent** authority to make business contracts on behalf of the company. The managing director's **actual** authority is whatever the board gives them.

If the articles provide for it the **board** may appoint one or more directors to be **managing directors**.

In their dealings with outsiders the managing director has **apparent authority** as agent of the company to **make business contracts**. No other director, even if they work full time, has that **apparent** authority as a director, though if they are employed as a manager they may have apparent authority at a slightly lower level.

The managing director's **actual authority** is whatever the board gives them.

Although a managing director (MD) has this special status, their appointment as MD may be **terminated** like that of any other director (or employee); they then revert to the position of an ordinary director.

Alternatively the company in general meeting may **remove them from their office of director** and they immediately cease to be MD since being a director is a necessary qualification for holding the post of MD.

7.1 Agency and the managing director

The directors are **agents of the company, not the members**. Where they have **actual or usual** authority they can **bind the company**. In addition a director may have **apparent authority** by virtue of **holding out**.

Holding out is a basic rule of the law of agency and we saw it in Chapter 17. This means, if the principal (the company) holds out a person as its authorised agent they are estopped from denying that they are its **authorised agent**. They are bound by a contract entered into by them on the company's behalf.

Key term

Apparent authority is the authority which an agent appears to have to a third party. A contract made within the scope of such authority will bind the principal even though the agent was not following their instructions.

Therefore, if the board of directors **permits a director** to behave as if he were a **managing director** duly appointed when in fact they are not, the company may be bound by their actions.

A managing director has, by virtue of their position, **apparent authority** to make commercial contracts for the company. Moreover if the board allows a director to enter into contracts, being aware of their dealings and taking no steps to disown them, the company will usually be bound.

Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd 1964

The facts: A company carried on a business as property developers. The articles contained a power to appoint a managing director but this was never done. One of the directors of the company, to the knowledge but without the express authority of the remainder of the board, acted as if he were managing director. He found a purchaser for an estate and also engaged a firm of architects to make a planning application. The company later refused to pay the architect's fees on the grounds that the director had no actual or apparent authority.

Decision: The company was liable since by its acquiescence it had represented that the director was a managing director with the authority to enter into contracts that were normal commercial arrangements and which the board itself would have been able to enter.

Exam focus point

Situations where the facts are similar to the *Freeman & Lockyer* case often occur in law exams so be prepared to spot them.

In the *Freeman & Lockyer* case, Diplock L J laid down four conditions which must be satisfied in claiming under the principle of **holding out**. The claimant must show that:

(a) A **representation** was made to them that the **agent had** the **authority** to enter on behalf of the company into the contract of the kind sought to be enforced.

(b) Such **representation** was **made by a person** who had **'actual' authority** to **manage** the **business** of the company.

The board of directors would certainly have actual authority to manage the company. Some commentators have also argued that the managing director has actual or apparent authority to make representations about the extent of the actual authority of other company agents. (However a third party cannot rely on the representations a managing director makes about their own actual authority).

(c) They were **induced** by the **representation** to enter into the contract; they had in fact relied on it.

(d) There must be **nothing** in the **articles** which would prevent the company from giving valid authority to its agent to enter into the contract.

Question

Directors' powers

Under the articles of association of Recycle Ltd the directors of the company need the consent of the general meeting by ordinary resolution to borrow sums of money in excess of £50,000. The other articles are all standard model articles.

Mary has been appointed managing director of the company and she holds 1% of the issued shares of the company. Early in May 20X5 Mary entered into two transactions for the benefit of Recycle Ltd. First, she arranged to borrow £100,000 from Conifer Bank Ltd, secured by a floating charge on the company's assets. She had not sought the approval of the members as required by the articles. Secondly, she placed a contract worth £10,000 with Saw Ltd to buy some agricultural machinery.

Advise the directors of Recycle Ltd whether they are bound by the agreements with Conifer Bank Ltd and Saw Ltd.

Answer

The enforceability of the loan agreement and floating charge by Conifer Bank Ltd against Recycle Ltd is determined by reference to s 40. The transaction is *intra vires* the company, but beyond the authority of the managing director. Mary failed to obtain an ordinary resolution of the company as required by its articles of association.

S 40 provides that, in favour of a person dealing in good faith with a company, the power of the board of directors to bind the company or (importantly in this case) to authorise others to do so, shall be deemed to be free of any limitation under the company's constitution.

There is no suggestion that Conifer Bank Ltd has not acted in good faith and it will be presumed that it has in fact acted in good faith unless the contrary is proved by the company.

The articles allow the board to appoint a managing director. In that position, Mary has apparent authority as agent of the company to make business contracts including the type of transaction entered into with Saw Ltd.

Under the Act, the restriction placed on her actual authority (by the article requiring an ordinary resolution) shall be deemed not to exist in favour of the third party, Conifer Bank Ltd. The power of the board to authorise Mary to bind the company is deemed to be free of any constitutional limitation.

In conclusion, Recycle Ltd will be bound to the contracts with both Conifer Bank Ltd and Saw Ltd.

8 Powers of an individual director

The position of any other individual director (not an MD) who is also an employee is that:

(a) They **do not have the apparent authority to make general contracts** which attaches to the position of MD, but they have **whatever apparent authority attaches** to their **management position**.

(b) **Removal** from the office of director may be a **breach** of their **service contract** if that agreement stipulates that they are to have the status of director as part of the conditions of employment.

9 Duties of directors

FAST FORWARD

The Company's Act 2006 sets out the **seven principal duties** of **directors**

The Company's Act 2006 sets out the **principal duties** that directors owe to their company. Many of these duties developed over time through the operation of **common law** and **equity,** or are **fiduciary duties** which have now been codified to make the law clearer and more accessible.

Point to note

When deciding whether a duty has been broken, the courts will consider the Companies Act primarily. All case law explained in this section applied before the 2006 Act and is included here to help you understand the types of situation that arise and how the law will be interpreted and applied by the courts in the future.

Key term

Fiduciary duty is a duty imposed upon certain persons because of the position of trust and confidence in which they stand in relation to another. The duty is more onerous than generally arises under a contractual or tort relationship. It requires full disclosure of information held by the fiduciary, a strict duty to account for any profits received as a result of the relationship, and a duty to avoid conflict of interest.

Broadly speaking directors must be **honest** and **not allow their personal interests to conflict with their duties as directors**. The directors are said to hold a **fiduciary position** since they make contracts as **agents** of the company and have control of its property.

The duties included in the Companies Act 2006 form a **code of conduct** for directors. They do not tell them what to do but rather create a framework that sets out how they are expected to **behave** generally. This code is important as it addresses situations where:

- A director may put their **own interests** ahead of the company's, and
- A director may be **negligent** and liable to an action under tort.

9.1 Who are the duties owed to?

Section 170 makes it clear that directors owe their duties to the company, **not** the members. This means that the **only company itself can take action against a director** who breaches them. However, it is possible for a member to bring a derivative claim against the director on behalf of the company.

The effect of the **duties are cumulative**, in other words, a director owes **every duty** to the company that could apply in any given situation. The Act provides guidance for this. Where a director is offered a bribe for instance they will be breaking the duty not to accept a benefit from a third party and they will also not be promoting the company for the benefit of the members.

When deciding whether or not a director has breached a duty, the court should consider their actions in the context of **each individual duty** in turn.

9.2 Who are the duties owed by?

Every person who is **classed as a director** under the Act owes the duties that are outlined below.

Certain aspects of the duties regarding conflicts of interest and accepting benefits from third parties also apply to **past directors**. This is to prevent directors from exploiting a situation for their own benefit by simply resigning. The courts are directed to apply duties to **shadow directors** where they would have been applied to them previously under common law and equity.

Directors must at all times continue to **act in accordance with all other laws**; no authorisation is given by the duties for a director to breach any other law or regulation.

9.3 The duties and the articles

The articles may provide more onerous regulations than the Act, but they may not reduce the level of duty expected unless it is in the following circumstances:

- If a director has **acted in accordance with the articles** they cannot be in breach of the duty to exercise independent judgement.
- Some **conflicts of interest by independent directors** are permissible by the articles.
- Directors will not be in breach of duty concerning **conflicts of interest** if they follow any **provisions in the articles for dealing with them** as long as the provisions are lawful.
- The company may **authorise anything** that would otherwise be a breach of duty.

9.4 The duties of directors

FAST FORWARD

The **statutory duties** owed by directors are to:

- Act within their powers
- Promote the success of the company
- Exercise independent judgement
- Exercise reasonable skill, care and diligence
- Avoid conflicts of interest
- Not to accept benefits from third parties
- Declare an interest in a proposed transaction or arrangement

We shall now consider the duties placed on directors by the Act. Where cases are mentioned it is to **demonstrate** the previous common law or equitable principle that courts will follow when interpreting and applying the Act.

9.4.1 Duty to act within powers (s 171)

The directors owe a duty to act in accordance with the company's constitution, and only to exercise powers for the purposes for what they were conferred. They have a **fiduciary duty to the company to exercise their powers bona fide in what they honestly consider to be the interests of the company**: Re *Smith and Fawcett Ltd 1942.* This honest belief is effective even if, in fact, the interests of the company were not served.

This duty is owed **to the company** and **not generally to individual shareholders**. The directors will not generally be liable to the members if, for instance, they purchase shares without disclosing information affecting the share price: *Percival v Wright 1902.*

In exercising the powers given to them by the articles the directors have a fiduciary duty not only to act *bona fide* but also only to use their powers for a proper purpose: *Bamford v Bamford 1969*

The powers are restricted to the **purposes** for **which they were given**. If the directors infringe this rule by exercising their powers for a collateral purpose the transaction will be invalid **unless** the **company** in **general meeting authorises it, or subsequently ratifies it**.

Most of the directors' powers are found in the **articles,** so this duty means that the directors must not act outside their power or the capacity of the company (in other words *ultra vires*).

If the irregular use of directors' powers is in the **allotment of shares** the votes attached to the new shares may not be used in reaching a decision in general meeting to sanction it.

Howard Smith Ltd v Ampol Petroleum Ltd 1974

The facts: Shareholders who held 55% of the issued shares intended to reject a takeover bid for the company. The directors honestly believed that it was in the company's interest that the bid should succeed. The directors therefore allotted new shares to the prospective bidder so that the shareholders opposed to the bid would then have less than 50% of the enlarged capital and the bid would succeed.

Decision: The allotment was invalid. 'It must be unconstitutional for directors to use their fiduciary powers over the shares in the company purely for the purpose of destroying an existing majority or creating a new majority which did not previously exist'.

Any **shareholder** may **apply to the court** to declare that a transaction in breach of s 171 should be set aside. However the practice of the courts is generally to **remit the issue** to the **members in general meeting** to see if the members wish to confirm the transaction. If the majority approve what has been done (or have authorised it in advance) that decision is treated as a proper case of **majority control** to which the minority must normally submit.

Hogg v Cramphorn 1966

The facts: The directors of a company issued shares to trustees of a pension fund for employees to prevent a takeover bid which they honestly thought would be bad for the company. The shares were paid for with money belonging to the company provided from an employees' benevolent and pension fund account. The shares carried 10 votes each and as a result the trustees and directors together had control of the company. The directors had power to issue shares but not to attach more than one vote to each. A minority shareholder brought the action on behalf of all the other shareholders.

Decision: If the directors act honestly in the best interests of the company, the company in general meeting can ratify the use of their powers for an improper purpose, so the allotment of the shares would be valid. But only one vote could be attached to each of the shares because that is what the articles provided.

Bamford v Bamford 1969

The facts: The directors of Bamford Ltd allotted 500,000 unissued shares to a third party to thwart a takeover bid. A month after the allotment a general meeting was called and an ordinary resolution was passed ratifying the allotment. The holders of the newly-issued shares did not vote. The claimants (minority shareholders) alleged that the allotment was not made for a proper purpose.

Decision: The ratification was valid and the allotment was good. There had been a breach of fiduciary duty but the act had been validated by an ordinary resolution passed in general meeting.

These cases can be distinguished from the *Howard Smith* case (where the allotment was invalid) in that in the *Howard Smith* case the original majority would not have sanctioned the use of directors' powers. In the *Bamford* case the decision could have been sanctioned by a vote which excluded the new shareholders.

Ratification is not effective when it attempts to validate a transaction when

- It constitutes **fraud on a minority**.
- It involves **misappropriation of assets**.
- The transaction **prejudices creditors' interests** at a time when the company is insolvent.

Under s 239, any resolution which proposes to ratify the acts of a director which are negligent in default or in breach of duty or trust regarding the company must exclude the director or any members connected with them from the vote.

Most of the cases discussed above concern the **duty of directors** to exercise their power to allot shares. This is only one of the powers given to directors that are subject to this **fiduciary duty**. Others include:

- Power to borrow
- Power to give security
- Power to refuse to register a transfer of shares
- Power to call general meetings
- Power to circulate information to shareholders

9.4.2 Duty to promote the success of the company (s 172)

An overriding theme of the Companies Act 2006 is the principle that the **purpose of the legal framework** surrounding companies should be **to help companies do business**. Their main purpose is to create wealth for the shareholders.

This theme is evident in the **duty of directors to promote the success of a company**. During the development of the Act, the independent Company Law Review recommended that company law should consider the interests of those who companies are run for. It decided that the new Act should embrace the principle of **'enlightened shareholder value'**.

In essence, this principle means that the law should encourage **long-termism** and **regard for all stakeholders** by directors and that **stakeholder interests** should be **pursued** in an **enlightened** and **inclusive** way.

To achieve this, a duty of directors to act in a way, which, in **good faith**, promotes the success of the company for the benefit of the members as a whole, was created. The requirements of this duty are difficult to define and possibly problematic to apply, so the Act provides directors with a **non-exhaustive list** of issues to keep in mind. When exercising this duty directors should consider:

- The **consequences of decisions** in the long term.
- The **interests of** their **employees**.
- The need to **develop good relationships** with **customers** and **suppliers**.
- The **impact of the company** on the **local community** and the **environment**.
- The desirability of **maintaining high standards of business conduct** and a **good reputation**.
- The need to **act fairly as between all members** of the company.

The list identifies areas of **particular importance** and **modern day expectations** of **responsible business behaviour**. For example, the interests of the company's employees and the impact of the company's operations on the community and the environment.

The **Act does not define** what should be regarded as the **success of a company**. This is down to a director's judgement in good faith. This is important as it ensures that business decisions are for the directors rather than the courts.

No guidance is given for what the **correct course of action** would be where the various s172 **duties are in conflict**. For example a decision to shut down an office may be in the long term best interests of the company but it is certainly not in the interests of the employees affected, nor the local community in which they live. Conflicts such as this are inevitable and could potentially leave directors open to breach of duty claims by a wide range of stakeholders if they do not deal with them carefully.

Exam focus point

This duty was the subject of a ten-mark question in December 2008. A full explanation of the duty was required to score well.

9.4.3 Duty to exercise independent judgement (s 173)

This is a simple duty that states directors must **exercise independent judgement.** They should **not delegate** their powers of decision-making or be **swayed by the influence of others**. Directors may delegate their functions to others, but they must continue to make independent decisions.

This duty is not infringed by acting in accordance with any agreement by the company that restricts the exercise of discretion by directors, or by acting in a way authorised by the company's constitution.

9.4.4 Duty to exercise reasonable skill, care and diligence (s 174)

Directors have a **duty of care** to show **reasonable skill, care and diligence**.

Section 174 provides that a director 'owes a duty to his company to exercise the same standard of care, skill and diligence that would be exercised by a reasonably diligent person with:

(a) The general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company; and

(b) The general knowledge, skill and experience that the director has.'

There is therefore a **reasonableness test** consisting of two parts:

(a) An **objective test**

Did the director act in a manner reasonably expected of a person performing the same role?

A director, when carrying out his functions, must show such **care** as could **reasonably** be expected from a **competent person** in that role. If a 'reasonable' director could be expected to act in a certain way, it is no defence for a director to claim, for example, lack of expertise.

(b) A **subjective test**

Did the director act in accordance with the skill, knowledge and experience that they actually have?

In the case of *Re City Equitable Fire and Insurance Co Ltd 1925* it was held that a director is expected to show the **degree of skill** which may **reasonably be expected** from a person of his knowledge and experience. The standard set is personal to the person in each case. An accountant who is a director of a mining company is not required to have the expertise of a mining engineer, but they should show the expertise of an accountant.

The duty to be competent extends to **non-executive directors**, who may be liable if they fail in their duty.

Dorchester Finance Co Ltd v Stebbing 1977

The facts: Of all the company's three directors S, P and H, only S worked full-time. P and H signed blank cheques at S's request who used them to make loans which became irrecoverable. The company sued all three; P and H, who were experienced accountants, claimed that as non-executive directors they had no liability.

Decision: All three were liable, P's and H's acts in signing blank cheques being negligent and not showing the necessary objective or subjective skill and care.

In other words, the **standard of care** is an objective 'competent' standard, plus a higher 'personal' standard of application. If the director actually had particular expertise that leads to a higher standard of competence being reasonably expected.

9.4.5 Negligence

The company may recover damages from its directors for loss caused by their negligence. However something more than imprudence or want of care must be shown. It must be shown to be a case of **gross negligence**. This was defined in *Overend Gurney & Co v Gibb 1872* as conduct such that 'no men with any degree of prudence, acting on their own behalf, would have entered into such a transaction as they entered into'.

Therefore, in the absence of fraud it was difficult to control careless directors effectively. The statutory provisions on disqualification of directors of insolvent companies and on liability for wrongful trading both set out how to judge a director's competence, and provide more effective enforcement (discussed below).

The company by decision of its members in general meeting decides whether to sue the directors for their negligence. Even if it is a case in which they could be liable **the court has discretion under s 1157 to relieve directors of liability** if it appears to the court that:

- The directors acted **honestly** and **reasonably**
- They **ought**, having regard to the circumstances of the case, **fairly to be excused**.

Re D' Jan of London Ltd 1993

The facts: D, a director of the company, signed an insurance proposal form without reading it. The form was filled in by D's broker. An answer given to one of the questions on the form was incorrect and the insurance company rightly repudiated liability for a fire at the company's premises in which stock worth some £174,000 was lost. The company became insolvent and the liquidator brought this action under s 212 of the Insolvency Act 1986 alleging D was negligent.

Decision: In failing to read the form D was negligent. However, he had acted honestly and reasonably and ought therefore to be partly relieved from liability by the Court under s 727 of the Companies Act 1985, (now s 1157 under the Companies Act 2006).

In the absence of **fraud**, **bad faith** or **ultra vires** the members may vote unanimously to forgive the director's negligence, even if it is those negligent directors who control the voting and exercise such forgiveness: *Multinational Gas & Petrochemical Co v Multinational Gas and Petrochemical Services Ltd 1983*. Where there is no fraud on the minority, a majority decision is sufficient: *Pavlides v Jensen 1956*.

9.4.6 Duty to avoid conflicts of interest (s 175)

Directors have a **duty to avoid circumstances** where their **personal interests conflict**, or may possibly conflict, **with the company's interests**. It may occur when a director makes personal use of information, property or opportunities belonging to the company, whether or not the company was able to take advantage of them at the time.

Therefore, directors must be careful not to breach this duty when they **enter into a contract** with their company or if they **make a profit in the course of being a director**.

This duty does not apply to a conflict of interest in relation to a **transaction** or **arrangement** with the **company**, provided the director declared an interest.

As **agents,** directors have a **duty to avoid a conflict of interest**. In particular:

- The directors must **retain their freedom of action** and **not fetter their discretion** by agreeing to vote as some other person may direct.
- The directors owe a fiduciary duty to **avoid a conflict of duty and personal interest.**
- The directors **must not obtain any personal advantage** from their position as directors **without the consent of the company** for whatever gain or profit they have obtained.

The following cases are important in the area of conflict of interest.

Regal (Hastings) Ltd v Gulliver 1942

The facts: The company owned a cinema. It had the opportunity of acquiring two more cinemas through a subsidiary to be formed with an issued capital of £5,000. However the company could not proceed with this scheme since it only had £2,000 available for investment in the subsidiary.

The directors and their friends therefore subscribed £3,000 for shares of the new company to make up the required £5,000. The chairman acquired his shares not for himself but as nominee of other persons. The company's solicitor also subscribed for shares. The share capital of the two companies (which then owned three cinemas) was sold at a price which yielded a profit of £2.80 per share of the new company in which the directors had invested. The new controlling shareholder of the company caused it to sue the directors to recover the profit which they had made.

Decision:

(a) The directors were **accountable** to the company for their profit since they had obtained it from an opportunity which came to them as directors.

(b) It was **immaterial** that the **company** had **lost nothing** since it had been unable to make the investment itself.

(c) The directors might have kept their profit if the company had **agreed** by resolution passed in general meeting that they should do so. The directors might have used their votes to approve their action since it was not fraudulent (there was no misappropriation of the company's property).

(d) The chairman was not accountable for the profit on his shares since he did not obtain it for himself. The solicitor was not accountable for his profit since he was **not a director** and so was not subject to the rule of accountability as a director for personal profits obtained in that capacity.

Industrial Development Consultants Ltd v Cooley 1972

The facts: C was managing director of the company which provided consultancy services to gas companies. A gas company was unlikely to award a particular contract to the company but C realised that, acting personally, he might be able to obtain it. He told the board of his company that he was ill and persuaded them to release him from his service agreement. On ceasing to be a director of the company C obtained the contract on his own behalf. The company sued him to recover the profits of the contract.

Decision: C was accountable to his old company for his profit.

Directors will not be liable for a breach of this duty if:

- The **members** of the company **authorised** their actions
- The **situation cannot reasonably be regarded** as likely to give rise to a conflict of interest
- The **actions have been authorised by the other directors**. This only applies if they are genuinely independent from the transaction and:
  - If the company is private – the articles do not restrict such authorisation, or
  - If it is public – the articles expressly permit it.

9.4.7 Duty not to accept benefits from third parties (s 176)

This duty **prohibits the acceptance of benefits** (including bribes) from third parties conferred by reason of them being director, or doing, (or omitting to do) something as a director. Where a director accepts a benefit that may also create or potentially create a conflict of interest, they will also be in breach of their s 175 duty (see above).

Unlike s 175, an act which would potentially be in breach of this duty **cannot be authorised** by the **directors**, but **members do have the right to authorise it**.

Directors will not be in breach of this duty if the acceptance of the benefit **cannot reasonably** be regarded as likely to give rise to a conflict of interest.

9.4.8 Duty to declare interest in proposed transaction or arrangement (s 177)

Directors are required to disclose to the other directors the nature and extent of any interest, direct or indirect, that they have in relation to a **proposed transaction** or **arrangement** with the **company**. Even if the director is not a party to the transaction, the duty may apply if they are aware, or ought reasonably to be aware, of the interest. For example, the interest of another person in a contract with the company may require disclosure under this duty if that other person's interest is a direct or indirect interest on the part of the director.

Directors are required to disclose their interest in any transaction **before** the company enters into the transaction.

Disclosure can be made by:

- Written notice
- General notice
- Verbally at a board meeting

Disclosure to the **members** is **not** sufficient to discharge the duty. Directors must declare the **nature** and **extent** of their interest to the **other directors** as well.

If the declaration becomes **void** or **inaccurate**, a **further declaration** should be made.

No declaration of interest is required if the director's interest in the transaction **cannot reasonably** be regarded as likely to give rise to a conflict of interest.

9.5 Consequences of breach of duty

Breach of duty comes under the **civil law** rather than criminal law and, as mentioned earlier, the company itself must take up the action. This usually means the other directors starting proceedings.

Consequences for breach include:

- **Damages** payable to the company where it has suffered loss.
- **Restoration** of company property
- **Repayment of any profits** made by the director
- **Rescission of contract** (where the director did not disclose an interest)

9.6 Declaration of an interest in an existing transaction or arrangement (s 182)

Directors have a statutory obligation to declare any direct or indirect interest in an existing transaction entered into by the company. This obligation is almost identical to the duty to disclose an interest in a proposed transaction or arrangement under s 177 (see above). However, that this section is relevant to transactions or arrangements that have already occurred.

A declaration under s 182 is **not** required if:

- It has **already been disclosed** as a proposed transaction under s 177
- The director is **not aware** of either
  - **The interest** they have in the transaction, or
  - In **the transaction** itself
- The director's interest in the transaction **cannot reasonably** be regarded as likely to give rise to a conflict of interest
- The **other directors are aware** (or reasonably should be aware) of the situation
- It concerns the **director's service contract** and it has been considered by a board meeting or special board committee

Where a declaration is required it should be made as soon as **reasonably practicable** either:

- By written notice
- By general notice
- Verbally at a board meeting

If the declaration becomes **void** or **inaccurate**, a **further declaration** should be made.

9.7 Other controls over directors

The table below summarises other statutory controls over directors included in the Companies Act 2006.

CA06 Ref	Control
188	Directors' service contracts lasting more than two years must be approved by the members.
190	Directors or any person connected to them may not acquire a non-cash asset from the company without approval of the members. This does not apply where the asset's value is less than £5,000, or less than 10% of the company's asset value. All sales of assets with a value exceeding £100,000 must be approved.
197	Any loans given to directors, or guarantees provided as security for loans provided to directors, must be approved by members.
198	Expands section 197 to prevent unapproved quasi-loans to directors (plcs only).
201	Expands section 197 to prevent unapproved credit transactions by the company for the benefit of a director (public companies only).
217	Non-contractual payments to directors for loss of office must be approved by the members.

9.8 Examples of remedies against directors

Remedies against directors for breach of duties include accounting to the company for a **personal gain**, **indemnifying the company**, and **rescission of contracts** made with the company.

The type of remedy varies with the breach of duty.

(a) The director may have to **account for a personal gain**: *Regal (Hastings) Ltd v Gulliver 1942*.

(b) They may have to **indemnify the company** against loss caused by their negligence such as an unlawful transaction which they approved.

(c) If they contract with the company in a conflict of interest the **contract may be rescinded by the company**. However, under common law rules the company cannot both affirm the contract and recover the director's profit: *Burland v Earle 1902.*

(d) The court may declare that a transaction is *ultra vires* or unlawful*: Re Lee Behrens & Co 1932*.

A company may, either by its **articles** or by **passing a resolution** in general meeting, **authorise or ratify** the conduct of directors in breach of duty. There are some limits on the power of members in general meeting to **sanction a breach of duty** by directors or to release them from their strict obligations.

(a) If the directors **defraud** the company and vote in general meeting to approve their own fraud, their votes are invalid (*Cook v Deeks 1916)*.

(b) If the directors **allot shares** to alter the balance of votes in a general meeting the votes attached to those shares may not be cast to support a resolution approving the issue (see *Bamford's* case).

9.9 Directors' liability for acts of other directors

A director is **not liable** for acts of fellow directors. However if they become aware of serious breaches of duty by other directors, they may have a duty to inform members of them or to take control of assets of the company without having proper delegated authority to do so. In such cases the director is **liable for their own negligence** in what they allow to happen and not directly for the misconduct of the other directors.

9.10 Directors' personal liability

As a general rule a director has no personal liability for the debts of the company – except:

- Personal liability **may arise** by **lifting the veil** of incorporation.
- A **limited company** may by its articles or by **special resolution** provide that its directors shall have unlimited liability for its debts
- A director may be **liable** to the **company's creditors** in certain circumstances.

Can a director be held personally liable for **negligent advice** given by his company? The case below shows that they can, but only when they assume responsibility in a personal capacity for advice given, rather than simply giving advice in their capacity as a director.

> *Williams and Another v Natural Life Health Foods Ltd 1998*
>
> *The facts:* The director was sued personally by claimants who claimed they were misled by the company's brochure. The director helped prepare the brochure, and the brochure described him as the source of the company's expertise. The claimants did not however deal with the director but with other employees.
>
> *Decision:* The House of Lords overruled the Court of Appeal, and ruled that the director was not personally liable. In order to have been liable, there would have had to have been evidence that the director had assumed personal responsibility. Merely acting as a director and advertising his earlier experience did not amount to assumption of personal liability.

9.11 Fraudulent and wrongful trading

In cases of **fraudulent or wrongful trading** liquidators can apply to the court for an order that those responsible (usually the directors) are liable to repay all or some specified part of the **company's debts**.

The liquidator should also report the facts to the Director of Public Prosecutions so that the DPP may **institute criminal proceedings**. We shall come back to these points in Chapter 17.

10 The company secretary

FAST FORWARD

> Every public company must have a **company secretary**, who is one of the officers of a company and may be a director. Private companies are not required to have a secretary.

Every public company must have a **company secretary**, who is one of the officers of a company and may be a director. Private companies are not required to have a secretary. In this case the roles normally done by the company secretary may be done by one of the directors, or an approved person. The secretary of state may require a public company to appoint a secretary where it has failed to do so.

10.1 Appointment of a company secretary

To be appointed as a company secretary to a plc, the directors must ensure that the candidate should be qualified (s 273) by virtue of:

- **Employment** as a plc's secretary for **three out of the five years** preceding appointment
- **Membership** of one of a list of **qualifying bodies**: the ACCA, CIMA, ICAEW, ICAS, ICAI or CIPFA
- **Qualification** as a **solicitor**, **barrister** or **advocate** within the UK
- **Employment** in a position or **membership** of a professional body that, in the opinion of the directors, **appears to qualify that person** to act as company secretary

They should also have the *'necessary knowledge and experience'* as deemed by the directors.

A **sole director** of a private company cannot also be the company secretary, but a company can have **two** or more joint secretaries. A **corporation** can fulfil the role of company secretary. A register of secretaries must be kept.

Under the **Combined Code** on **Corporate Governance** (See Chapter 18), the appointment of the company secretary is a matter for the board as a whole.

10.2 Duties of a company secretary

The specific **duties** of each company secretary are **determined by the directors** of the company. As a company officer, the company secretary is responsible for ensuring that the company complies with its statutory obligations. In particular, this means:

- **Establishing** and **maintaining** the company's **statutory registers**
- **Filing accurate returns** with the Registrar on time
- **Organising** and **minuting** company and **board meetings**
- **Ensuring** that **accounting records** meet **statutory requirements**
- **Ensuring** that **annual accounts** are **prepared** and **filed** in accordance with **statutory requirements**
- **Monitoring statutory requirements** of the company
- **Signing company documents** as may be required by law

Under the Combined Code on Corporate Governance, the company secretary must:

- **Ensure good information flows** within the board and its committees
- **Facilitate induction of board members** and assist with professional development
- **Advise** the **chairman** and the **board** on all **governance issues**

10.3 Powers and authority of a company secretary

The powers of the company secretary have historically been very limited. However, the common law increasingly recognises that they may be able to act as agents to exercise apparent or **ostensible authority**, therefore they may enter the company into contracts connected with the administrative side of the company.

Panorama Developments (Guildford) Ltd v Fidelis Furnishing Fabrics Ltd 1971

The facts: B, the secretary of a company, ordered cars from a car hire firm, representing that they were required to meet the company's customers at London Airport. Instead he used the cars for his own purposes. The bill was not paid, so the car hire firm claimed payment from B's company.

Decision: B's company was liable, for he had apparent authority to make contracts such as the present one, which were concerned with the administrative side of its business. The decision recognises the general nature of a company secretary's duties.

11 The company auditor

FAST FORWARD

Every company (apart from certain small companies) must appoint appropriately qualified **auditors**. An audit is a check on the stewardship of the directors.

Every company (except a dormant private company and certain small companies) must **appoint auditors** for each financial year: s 475.

11.1 Appointment

The **first auditors** may be appointed by the directors, to hold office until the **first general meeting** at which their appointment is considered.

Subsequent auditors may not take office until the previous auditor has ceased to hold office. They will hold office until the end of the next financial period (private companies) or the next accounts meeting (public companies) unless re-appointed.

Appointment of auditors	
Members	• Usually appoint auditor in general meeting by ordinary resolution. • Auditors hold office from 28 days after the meeting in which the accounts are laid until the end of the corresponding period the next year. This is the case even if the auditors are appointed at the meeting where the accounts are laid. • May appoint in general meeting to fill a casual vacancy.
Directors	• Appoint the first ever auditors. They hold office until the end of the first meeting at which the accounts are considered. • May appoint to fill a casual vacancy.
Secretary of State	• May appoint auditors if members fail to. • Company must notify Secretary of State within 28 days of the general meeting where the accounts were laid.

11.1.1 Eligibility as auditor

Membership of a **Recognised Supervisory Body** is the main prerequisite for eligibility as an auditor. An audit firm may be either a body corporate, a partnership or a sole practitioner.

The Act requires an auditor to hold an **'appropriate qualification'**. A person holds an 'appropriate qualification' if they:

- Have satisfied **existing criteria** for appointment as an auditor
- Hold a **recognised qualification** obtained in the UK
- Hold an **approved overseas qualification**

11.1.2 Ineligibility as auditor

Under the Companies Act 2006, a person may be ineligible on the grounds of **'lack of independence'**.

A person is ineligible for appointment as a company auditor if they are:

- An **officer** or **employee** of the company being audited
- A **partner** or **employee** of such a person
- A **partnership** in which such a person is a partner
- **Ineligible** by virtue of the above for appointment as auditor of any parent or subsidiary undertaking or a subsidiary undertaking of any parent undertaking of the company, and there exists between them or any associate (of theirs) and the company (or company as referred to above) a **connection** of any description as may be specified in regulations laid down by Secretary of State.

11.1.3 Effect of lack of independence or ineligibility

No person may act as auditor if they lack independence or become ineligible. If during their term of office an auditor loses their independence or eligibility they must **resign** with immediate effect, and **notify** their client of their resignation giving the reason.

A person continuing to act as auditor despite losing their independence or becoming ineligible is **liable to a fine**. However it is a defence if they can prove they were not aware that they lost independence or became ineligible.

The legislation does **not** disqualify the following from being an auditor of a limited company:

- A shareholder of the company
- A debtor or creditor of the company
- A close relative of an officer or employee of the company

However, the **regulations** of the **accountancy bodies** applying to their own members are **stricter than statute in this respect**.

11.2 Reappointing an auditor of a private company

The above rules on appointment make reference to a **meeting** where the accounts are laid. This is not always relevant for private companies as under the Act they are not required to hold an AGM or lay the accounts before the members. Therefore **auditors of private companies are deemed automatically reappointed** unless one of the following circumstances apply.

- The auditor was **appointed by the directors** (most likely when the first auditor was appointed).
- The **articles require formal reappointment**.
- **Members holding 5% of the voting rights** serve notice that the auditor should not be reappointed s 488.
- A **resolution** (written or otherwise) has been passed that prevents reappointment.
- The **directors have resolved that auditors should not be appointed** for the forthcoming year as the company is likely to be exempt from audit.

11.3 Auditor remuneration

Whoever appoints the auditors has power to **fix their remuneration** for the period of their appointment. It is usual when the auditors are appointed by the general meeting to leave it to the directors to fix their remuneration (by agreement at a later stage). The auditors' remuneration must be **disclosed** in a **note to the accounts**.

11.4 Exemption from audit

Certain **companies** are exempt from audit provided the following conditions are fulfilled.

(a) A company is totally exempt from the annual audit requirement in a financial year if its turnover for that year is **not more** than **£5,600,000**, and its **balance sheet total** is **not more than £2.8 million**.

(b) The exemptions do not apply to **public companies**, **banking** or **insurance companies** or those subject to a **statute-based regulatory regime**.

(c) The company is **non-commercial**, **non-profit making public sector body** which is subject to audit by a **public sector auditor**.

(d) **Members** holding **10%** or more of the capital of any company can veto the exemption.

(e) **Dormant companies** which qualify for exemption from an audit as a dormant company.

11.5 Duties of auditors

The **statutory duty** of auditors is to report to the members whether the accounts give a **true and fair view** and have been properly prepared in accordance with the Companies Act.

They must also:

- **State** whether or not the **directors' report** is **consistent** with the **accounts**.
- For **quoted companies**, **report** to the members on the **auditable** part of the **directors' remuneration report** including whether or not it has been properly prepared in accordance with the Act.
- Be **signed** by the **auditor**, stating their **name**, and **date**. Where the auditor is a firm, the **senior auditor** must sign in their **own name** for, and on behalf, of the auditor.

To fulfil their statutory duties, the auditors **must carry out such investigations as are necessary** to form an opinion as to whether:

(a) **Proper accounting records** have been kept and proper returns adequate for the audit have been received from branches.

(b) The **accounts** are in **agreement** with the **accounting records**.

(c) The **information** in the **directors' remuneration report** is consistent with the **accounts**.

The auditors' report must be **read** before any general meeting at which the accounts are considered and must be open to inspection by members. Auditors have to make disclosure of other services rendered to the company and the remuneration received.

Where an auditor **knowingly** or **recklessly** causes their report to be **materially misleading**, **false** or **deceptive**, they commit a criminal offence and may be liable to a **fine**: s 507.

11.6 Rights of auditors

FAST FORWARD

The Companies Act provide **statutory rights** for auditors to enable them to carry out their duties.

The **principal rights** of auditors, excepting those dealing with resignation or removal, are set out in the table below, and the following are notes on more detailed points.

Access to records	A right of access at all times to the books, accounts and vouchers of the company: s 499 (1)
Information and explanations	A right to require from the company's officers, employees or any other relevant person, such information and explanations as they think necessary for the performance of their duties as auditors: s 499 (1)
Attendance at/notices of general meetings	A right to attend any general meetings of the company and to receive all notices of and communications relating to such meetings which any member of the company is entitled to receive: s 502 (2)
Right to speak at general meetings	A right to be heard at general meetings which they attend on any part of the business that concerns them as auditors: s 502 (2)
Rights in relation to written resolutions	A right to receive a copy of any written resolution proposed: s 502 (1)

If auditors have **not received** all the information and explanations they consider necessary, they should state this fact in their audit report.

The Act makes it an **offence** for a company's officer knowingly or recklessly to make a statement in any form to an auditor which:

- Conveys or purports to convey any information or explanation required by the auditor and
- Is materially misleading, false or deceptive

The **penalty** is a maximum of two years' imprisonment, a fine or both.

11.7 Auditors' liability

Under s 532 any **agreement** between an auditor and a company that seeks to **indemnify the auditor** for their own negligence, default, or breach of duty or trust is **void**. However, under s 534, an agreement can be made which **limits the auditor's liability** to the company. Such **liability limitation agreements** can only stand for **one financial year** and must therefore be replaced annually.

Liability can only be **limited** to what is **fair and reasonable** having regard to the auditor’s responsibilities, their contractual obligations and the professional standards expected of them. Such agreements must be approved by the members and **publicly disclosed** in the **accounts** or **directors' report**.

11.8 Termination of auditors' appointment

FAST FORWARD

Auditors may leave office in the following ways: **resignation**; **removal from office** by an ordinary resolution with special notice passed before the end of their term; **failing** to **offer themselves** for **re-election**; and **not being re-elected** at the general meeting at which their term expires.

Departure of auditors from office can occur in the following ways.

(a) Auditors may **resign** their appointment by giving notice in writing to the company delivered to the registered office.

(b) Auditors may **decline reappointment**.

(c) Auditors may be **removed** from office before the expiry of their appointment by the passing of an ordinary resolution in general meeting. Special notice is required and members and auditors must be notified. **Private companies cannot remove an auditor by written resolution;** a meeting must be held.

(d) Auditors **do not have to be reappointed** when their term of office expires, although in most cases they are. Special notice must be given of any resolution to appoint auditors who were not appointed on the last occasion of the resolution, and the members and auditor must be notified.

Where a private company resolves to **appoint** a replacement auditor by **written resolution**, copies of the resolution must be sent to the proposed and outgoing auditor. The outgoing auditor may circulate a **statement of reasonable length** to the members if they notify the company within 14 days of receiving the copy of the written resolution.

11.8.1 Resignation of auditors

FAST FORWARD

However auditors leave office they must either: state there are **no circumstances** which should be brought to **members' and creditors' attention**; or list **those circumstances**. Auditors who are resigning can also: **circulate a statement** about their resignation to members; **requisition a general meeting'**, **or speak** at a general meeting.

Procedures for resignation of auditors	
Statement of circumstances	Auditors must deposit a statement at the registered office with their resignation stating: • For quoted companies – the circumstances around their departure. • For non-quoted public companies and all private companies – there are no circumstances that the auditor believes should be brought to the attention of the members or creditors. • If there are such circumstances the statement should describe them. • Statements should also be submitted to the appropriate audit authority.
Company action	• The company must send notice of the resignation to the Registrar. • The company must **send** a copy of the statement of circumstances to **every person entitled to receive a copy of the accounts.**
Auditor rights	If the auditors have deposited a statement of circumstances, they may: • Circulate a statement of reasonable length to the members • Requisition a general meeting to explain their reasons: s 518 • Attend and speak at any meeting where appointment of successors is to be discussed.

If the auditors decline to seek reappointment at an AGM, they must nevertheless fulfil the requirements of a **statement of the circumstances** just as if they had resigned.

The reason for this provision is to prevent auditors who are unhappy with the company's affairs keeping their suspicions secret. The statement must be deposited not less than **14 days** before the time allowed for next appointing auditors.

11.8.2 Removal of the auditor from office

Procedures for removal from office	
Auditor representations	If a resolution is proposed either to: • Remove the auditors before their term of office expires or • Change the auditors when their term of office is complete the auditors have the right to make representations of reasonable length to the company
Company action	The company must: • Notify members in the notice of the meeting of the representations • Send a copy of the representations in the notice • If it is not sent out, the auditors can require it is read at the meeting
Attendance at meeting	Auditors removed before expiry of their office may: • Attend the meeting at which their office would have expired • Attend any meeting at which the appointment of their successors is discussed
Statement of circumstances	If auditors are removed at a general meeting they must: • Make a statement of circumstances for members and creditors as above.

Exam focus point

Remember that:

(a) A statement of circumstances/no circumstances must be deposited **however** the auditors leave office.

(b) The auditors have **additional rights** depending on how they leave office.

In the exam you **must** read any question on this area carefully to ensure you answer it correctly.

Chapter Roundup

- Any person who occupies the position of director is treated as such, the test being one of **function**.
- The method of appointing directors, along with their rotation and co-option is **controlled** by the **articles.**
- Directors are entitled to **fees** and **expenses** as directors as per the articles, and **emoluments** (and compensation for loss of office) as per their service contracts (which can be inspected by members). Some details are published in the directors' remuneration report along with the accounts.
- A director may vacate office as director due to: **resignation**; **not going** for **re-election**; **death**; **dissolution** of the company; **removal**; **disqualification**.
- Directors may be required to vacate office because they have been disqualified on grounds dictated by the articles. Directors **may** be disqualified from a wider range of company involvements under the Company Directors Disqualification Act 1986 (CDDA).
- Directors may be **disqualified** from acting as directors or being involved in the management of companies in a number of circumstances. They must be disqualified if the company is insolvent, and the director is found to be unfit to be concerned with management of a company.
- The **powers** of the directors are **defined** by the **articles**.
- Directors' powers may be restricted by statute or by the articles. The directors have a duty to exercise their powers in what they honestly believe to be the **best interests** of the company and for the **purposes** for which the powers are given.
- One or more directors may be appointed by the board as **managing director**. The managing director has **apparent** authority to make business contracts on behalf of the company. The managing director's **actual** authority is whatever the board gives them.
- The Company's Act 2006 sets out the **seven principal duties** of **directors**.
- The **statutory duties** owed by directors are to:

  – Act within their powers
  – Promote the success of the company
  – Exercise independent judgement
  – Exercise reasonable skill, care and diligence
  – Avoid conflicts of interest
  – Not accept benefits from third parties
  – Declare an interest in a proposed transaction or arrangement
- Every public company must have a **company secretary**, who is one of the officers of a company and may be a director. Private companies are not required to have a secretary.
- Every company (apart from certain small companies) must appoint appropriately qualified **auditors**. An audit is a check on the stewardship of the directors.
- The Companies Act provide **statutory rights** for auditors to enable them to carry out their duties.
- Auditors may leave office in the following ways: **resignation**; **removal from office** by an ordinary resolution with special notice passed before the end of their term; **failing** to **offer themselves** for **re-election**; and **not being re-elected** at the general meeting at which their term expires.
- However auditors leave office they must either: state there are **no circumstances** which should be brought to **members' and creditors' attention**; or list **those circumstances**. Auditors who are resigning can also: **circulate a statement** about their resignation to members; **requisition a general meeting**; **or speak** at a general meeting.

Quick Quiz

1 Model articles provide a number of rules on retirement and re-election of directors. These include which of the following?

   A Every year one third of the directors (or the nearest number thereto) shall retire.

   B The managing director and any other director holding executive office are not subject to retirement by rotation and are excluded from the reckoning of the one third figure.

   C Those retiring will be those in service longest since their last election.

   D Directors appointed to the board during the year are not included in the calculation.

2 **Fill in the blanks** in the statements below.

   Under model articles directors are authorised to m……………….. the b……………….. of the company, and e……………….. the p………………..of the company.

3 Under which of the following grounds may a director be disqualified if he is guilty, and under which must a director be disqualified?

   A Conviction of an indictable offence in connection with a company

   B Persistent default with the provisions of company legislation

   C Wrongful trading

   D Director of an insolvent company whose conduct makes him unfit to be concerned in the management of the company

4 What is the extent of a managing director's actual authority?

5 What are the two principal ways by which members can control the activities of directors?

6 A public company must have two directors, a private company only needs one.

   True ☐

   False ☐

7 The directors of a company are in breach of the rule requiring them to act for a proper purpose. A general meeting can

   A Do nothing that will authorise the transaction
   B Authorise the transaction by ordinary resolution
   C Authorise the transaction by special resolution only
   D Relieve the directors of any liability under the transaction by special resolution only

8 Describe the subjective test that directors must pass in order to meet their duty of care.

9 A private company with a sole director is not legally required to have a company secretary, but if it does, the sole director cannot also be the company secretary.

   True ☐

   False ☐

10 Name two reasons a person would be ineligible to be an auditor under Companies Act 2006.

   (1) ....

   (2) ....

Answers to Quick Quiz

1. C and D are correct. One half of the directors shall retire each year. Executive directors excluding the MD are subject to retirement by rotation.
2. Under model articles directors are authorised to **manage** the **business** of the company, and **exercise all** the **powers** of the company.
3. A to C are grounds under which a director may be disqualified; D is grounds under which a director must be disqualified.
4. The actual authority is whatever the board gives them.
5. Appointing and removing directors in general meeting

   Reallocating powers by altering the articles
6. True. Private companies only need one director.
7. B. This was the decision in *Bamford v Bamford 1969*.
8. A director is expected to show the degree of skill, knowledge and expertise that they actually have in order to meet the subjective test.
9. True. Sole directors cannot be company secretaries. Private companies are not legally required to have a company secretary.
10. Any of:

    (1) Is an officer/employee of the company being audited
    (2) A partner or employee of a person in (1)
    (3) A partnership in which (1) is a partner
    (4) Ineligible by (1), (2) and (3) to be auditor of any of the entity's subsidiaries

Now try the question below from the Exam Question Bank

Number	Level	Marks	Time
Q17	Examination	10	18 mins

16

Company meetings and resolutions

Topic list	Syllabus reference
1 The importance of meetings	F3(a)
2 General meetings	F3(a)
3 Types of resolutions	F3(d)
4 Calling a meeting	F3(b)
5 Proceedings at meetings	F3(c)
6 Class meetings	F3(a)
7 Single member private companies	F3(a-d)

Introduction

In this chapter we consider the **procedures** by which companies are controlled by the shareholders, namely general meetings and resolutions. These afford members a measure of protection of their investment in the company. There are many transactions which, under the Act, cannot be entered into without a **resolution** of the company.

Moreover, a general meeting at which the annual accounts and the auditors' and directors' reports will be laid must normally be held by public companies annually. This affords the members an opportunity of questioning the directors on their **stewardship**.

Study guide

		Intellectual level
F3	**Company meetings and resolutions**	
(a)	Distinguish between types of meetings: ordinary general meetings and annual general meetings	1
(b)	Explain the procedure for calling such meetings	2
(c)	Detail the procedure for conducting company meetings	1
(d)	Distinguish between types of resolutions: ordinary, special and written	2

Exam guide

For the exam you must be quite clear about the different types of resolution, when each type is used, and the percentage vote needed for each type to be passed. This topic lends itself to knowledge questions. However, resolutions in particular are important in many areas of the corporate part of the syllabus and meetings of members are an important control on the acts of the directors. Therefore, this topic could easily be incorporated into an application question.

1 The importance of meetings

FAST FORWARD

Although the management of a company is in the hands of the directors, the **decisions which affect the existence of the company**, its structure and scope are **reserved to the members** in general meeting.

The decision of a general meeting is only valid and binding if the meeting is **properly convened** by notice and if the **business** of the meeting is **fairly** and **properly conducted**. Most of the rules on company meetings are concerned with the issue of notices and the casting of votes at meetings to carry resolutions of specified types.

1.1 Control over directors

The members in general meeting can exercise control over the directors, though only to a limited extent.

(a) Under normal procedure **one half** of the **directors retire** at each annual general meeting though they may offer themselves for re-election. The company may remove directors from office by **ordinary resolution**: s 168.

(b) Member approval in general meeting is required if the directors wish to:

- **Exceed their delegated power** or to use it for other than its given purpose
- **Allot shares** (unless private company with one class of shares)
- **Make a substantial contract** of sale or purchase with a director
- Grant a director a **long-service agreement**

(c) The **appointment and removal of auditors** is normally done in general meeting.

1.2 Resolution of differences

In addition, general meetings are the means by which **members resolve differences** between themselves by voting on resolutions.

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2 General meetings

FAST FORWARD

There are two kinds of general meeting of members of a company:

- **Annual general meeting (AGM)**
- **General meetings at other times**

2.1 Annual general meeting (AGM)

The **AGM** plays a major role in the life of a public company although often the business carried out seems fairly routine. It is a statutorily protected way for members to have a regular assessment and discussion of their company and its management.

Private companies are **not required** to have an **AGM** each year and therefore their business is usually conducted through **written resolutions**. However, members holding sufficient shares or votes can request a general meeting or written resolution.

	Rules for directors calling an AGM
Timing s 336	• Public companies must hold an AGM within **six months** of their year end
Notice s 337	• Must be in **writing** and in **accordance** with the **articles** • May be in **hard** or **electronic form** and may also by means of a **website** (s 308) • At least **21 days notice** should be given; a longer period may be specified in the articles • Shorter notice is only **valid** if all members agree • The notice must specify the **time**, **date** and **place** of the meeting and that the meeting is an AGM • Where notice is given on a **website** it must be available from the **date of notification** until the **conclusion of the meeting** (s 309)

The business of an annual general meeting usually includes:

- Considering the accounts
- Receiving the directors' report, the directors' remuneration report and the auditors' report
- Dividends
- Electing directors
- Appointing auditors

2.2 General meetings at other times

2.2.1 Directors

The **directors** may have power under the articles to convene a general meeting whenever they see fit.

2.2.2 Members

The directors of **public and private** companies may be required to convene a general meeting by **requisition of the members:** s 303.

Rules for members requisitioning a general meeting (s 303)	
Shareholding	• The requisitioning members of public companies must hold at least **10%** of the **paid up share capital** holding **voting rights**. In private companies they need either **5%** or **10%**, depending on when there was last a meeting at which the members had a right to vote. Over 12 months ago = 5%; under 12 months = 10%
Requisition	• They must deposit a **signed requisition** at the registered office or make the request in electronic form • This must state the 'objects of the meeting': the **resolutions proposed** (s 303(5))
Date	• A notice conveying the meeting must be set out within **21 days** of the requisition • It must be held within **28 days** of the notice calling to a meeting being sent out. • If the directors have not called the meeting within 21 days of the requisition, the **members may convene** the meeting for a date within 3 months of the deposit of the requisition
Quorum	• If **no quorum** is present, the meeting is **adjourned**.

2.2.3 Court order

The court, on the application of a director or a member entitled to vote, may order that a meeting shall be held and may give instructions for that purpose including fixing a quorum of one: s 306.

This is a method of last resort to resolve a deadlock such as the refusal of one member out of two to attend (and provide a quorum) at a general meeting.

2.2.4 Auditor requisition

An auditor who gives a statement of circumstances for their resignation or other loss of office in their written notice may also requisition a meeting to receive and consider their explanation: s 518.

2.2.5 Loss of capital by public company

The directors of a public company must convene a general meeting if the net assets fall to half or less of the amount of its called-up share capital: s 656.

3 Types of resolution

FAST FORWARD

A meeting can pass two types of resolution. **Ordinary resolutions** are carried by a simple majority (more than 50%) of votes cast and requiring 14 days' notice. **Special resolutions**, require a 75% majority of votes cast and also 14 days notice.

A meeting reaches a decision by passing a resolution (either by a show of hands or a poll). There are **two major kinds** of resolution, and an additional one for **private** companies.

Types of resolution	
Ordinary (s 282)	For most business Requires simple (50%+) majority of the votes cast 14 days notice
Special (s 283)	For major changes Requires 75% majority of the votes cast 14 days notice
Written (for private companies)	Can be used for all general meeting resolutions except for removing a director or auditor before their term of office expires. Either a simple (50%+) or 75% majority is required depending on the business being passed.

Exam focus point

There are not too many ways resolutions can be tested. You are most likely to be asked to explain the three types as in December 2008.

3.1 Differences between ordinary and special resolutions

Apart from the required size of the majority and period of notice, the main differences between the types of resolution are as follows.

(a) The **text** of **special resolutions** must be **set out** in **full** in the notice convening the meeting, and it must be described as a special resolution. This is not necessary for an ordinary resolution if it is routine business.

(b) A **signed copy** of every **special resolution** must be **delivered** to the **Registrar** for filing. **Some ordinary resolutions**, particularly those relating to share capital, have to be **delivered** for filing but many do not.

3.2 Special resolutions

A special resolution is required for **major changes** in the company such as the following.

- A change of name
- Restriction of the objects or other alteration of the articles
- Reduction of share capital
- Winding up the company
- Presenting a petition by the company for an order for a compulsory winding up

Question — Notice period

The period of notice for a general meeting at which a special resolution is proposed is:

A 14 days
B 21 days
C 28 days
D 42 days

Answer

A A general meeting at which a special resolution is proposed requires 14 days' notice.

3.3 Written resolutions

FAST FORWARD

A private company can pass any decision needed by a **written resolution**, except for removing a director or auditor before their term of office has expired.

As we saw earlier, a private company is **not** required to hold an **AGM**. Therefore the Act provides a mechanism for directors and members to conduct business solely by **written resolution**.

3.3.1 Written resolutions proposed by directors

Copies of the resolution proposed by directors must be sent to **each member** eligible to vote by hard copy, electronically or by a website. Alternatively, the same copy may be sent to each member in turn.

The resolution should be accompanied by a statement informing the member:

- How to **signify their agreement** to the resolution
- The **date** the resolution must be passed by

3.3.2 Written resolutions proposed by members

Members holding 5% (or lower if authorised by the articles) of the **voting rights** may request a written resolution providing it:

- **Would be effective** (not prevented by the articles or law)
- Is **not defamatory, frivolous** or **vexatious**

A **statement** containing no more than **1,000 words** on the subject of the resolution may accompany it.

Copies of the resolution, and statements containing information on the subject matter, how to agree to it and the date of the resolution must be sent to each member within **21 days** of the request for resolution.

Expenses for circulating the resolution **should be met by the members** who requested it unless the company resolves otherwise.

The company may **appeal to the court** not to circulate the 1,000 word statement by the members if the rights provided to the members are being abused by them.

3.3.3 Agreement

The members may indicate their agreement to the resolution in **hard copy** or **electronically**.

If no **period for agreement** is specified by the articles, then the default period is **28 days** from the date the resolution was circulated. Agreement after this period is ineffective.

Once agreed, a member **may not revoke** their decision.

Either a **simple** (50% plus one) or **75% majority** is required to pass a written resolution depending on the nature of the business being decided.

Three further points should be noted concerning written resolutions.

(a) Written resolutions can be used **notwithstanding any provisions** in the company's **articles**.

(b) A written resolution **cannot** be **used to remove a director or auditor** from office, since such persons have a right to **speak** at a **meeting**.

(c) **Copies of written resolutions** should be **sent to auditors** at or before the time they are sent to shareholders. Auditors do not have the right to object to written resolutions. If the auditors are not sent a copy, the resolution remains valid; however the directors and secretary will be liable to a fine. The purpose of this provision is to ensure auditors are kept informed about what is happening in the company.

Question — Resolutions

Briefly explain the main features of the following types of resolution which may be passed at a general meeting of a company:

(a) An ordinary resolution
(b) A special resolution

Answer

(a) Ordinary resolutions require a simple majority of votes cast (ie over 50%). 14 days notice is sufficient. Ordinary resolutions of a routine nature need not be set out in full in the notice of an annual general meeting, and most ordinary resolutions need not be filed with the Registrar.

(b) Special resolutions also require a 75% majority of votes cast and also require 14 days notice of the intention to propose such a resolution. The full text of the resolution should be set out in the notice.

4 Calling a meeting

FAST FORWARD

A meeting cannot make valid and binding decisions until it has been properly convened. Notice of general meetings must be given **14 days** in advance of the meeting. The notice should contain **adequate information** about the meeting.

Meetings must be called by a **competent person** or authority.

A meeting cannot make valid and binding decisions until it has been properly convened according to the company's articles, though there are also statutory rules.

(a) The meeting must generally be **called by** the **board of directors** or other competent person or authority.

(b) The notice must be issued to members in advance of the meeting so as to give them **14 days'** 'clear notice' of the meeting. The members may agree to waive this requirement (see below).

(c) The **notice** must be sent to every member (or other person) entitled to receive the notice.

(d) The notice must include any information **reasonably necessary** to enable shareholders to know in advance what is to be done.

(e) As we saw earlier members may require the directors to call a meeting if:

 (i) They hold at least **10% of the voting rights** (5% for a private company if 12 months have elapsed since the last meeting)

 (ii) They provide a **statement of the general business** to be conducted and the text of any proposed resolution

 The directors must within **21 days call a meeting** to be held no later than **28 days from the date of the notice** they send calling the meeting.

In most cases the notice need **not** be sent to a member whose only shares do not give him a right to attend and vote (as is often the position of **preference shareholders**)

4.1 Electronic communication

We have already seen that **notice** may be given by means of a **website** and in **electronic form** (s 308). Section 333 extends this by deeming that where a company gives an **electronic address** in a notice calling a meeting, any information or document relating to the meeting may be sent to that address.

4.2 Timing of notices

FAST FORWARD

Clear notice must be given to members. **Notice** must be **sent to all members** entitled to receive it.

Members may – and in small private companies often do – waive the required notice. For **short notice** to be effective:

(a) All **members** of a public company must consent in respect of an **AGM**.

(b) In **any other case** a **majority of members** who hold at least **90%** of the **issued shares** or voting rights must consent: 95% is required by a public company.

The following specific rules by way of exception should be remembered.

(a) When special notice of a resolution is given to the company in the two circumstances mentioned in Section 4.3 below, it must be given **28 days** in advance as prescribed.

(b) In a **creditors' voluntary winding up** there must be at least **7 days' notice** of the **creditors' meeting** (to protect the interests of creditors). The members may shorten the period of notice down to 7 days but that is all: s 98 IA.

The **clear days rule** in s 360 provides that the day of the meeting and the day the notice was given are **excluded** from the required notice period.

4.3 Special notice of a resolution

FAST FORWARD

Special notice of 28 days of intention to propose certain resolutions (removal of directors/auditors) must be given.

Key term

Special notice is notice of 28 days which must be given to a company of the intention to put certain types of resolution at a company meeting.

Special notice must be given **to the company** of the intention to propose a resolution for any of the following purposes.

- To **remove** an **auditor** or to **appoint** an **auditor other** than the **auditor** who was **appointed** at the **previous year's meeting**
- To **remove a director from office** or to appoint a substitute in their place after removal

A member may request a resolution to be passed at a particular meeting. In this case, the **member must give special notice** of their intention **to the company** at **least 28 days** before the date of the meeting. If, however, the company calls the meeting for a date less than 28 days after receiving the special notice that notice is deemed to have been **properly given**.

On receiving special notice a **public company may be obliged** to **include the resolution** in the **AGM notice** which it issues.

If the company gives notice to members of the resolution it does so by a **21 day notice** to them that special notice has been received and what it contains. If it is not practicable to include the matter in the notice of meeting, the company may give notice to members by newspaper advertisement or any other means permitted by the articles.

Where special notice is received of intention to propose a resolution for the removal of a director or to change the auditor, a copy must be sent to the **director** or **auditor**. This is to allow them to exercise their statutory right to defend themself by issuing a memorandum and/or addressing the meeting in person.

The essential point is that a **special notice is given to the company**; it is **not a notice from the company to members** although it will be followed (usually) by such notice.

4.4 Members requisitioning a resolution

FAST FORWARD

Members rather than directors may be able to requisition resolutions. This may be achieved by requesting the directors call a meeting, or proposing a resolution to be voted on at a meeting already arranged.

The directors normally have the **right to decide** what resolutions shall be included in the notice of a meeting. However, apart from the requisition to call a general meeting, members can also take the initiative to requisition certain resolutions be considered at the AGM.

Rules for members requisitioning a resolution at the AGM	
Qualifying holding s 338	• The members must represent 5% of the voting rights, or • Be at least 100 members holding shares with an average paid up of £100, per member
Request s 338	• Must be in hard copy or electronic form, identify the resolution and be delivered at least 6 weeks in advance of an AGM or other general meeting

Rules for members requisitioning a resolution at the AGM	
Statement **s 314**	• Members may request a statement (<1,000 words) be circulated to all members by delivering a **requisition**. Members with a qualifying holding may request a statement regarding their own resolution or any resolution proposed at the meeting • The company must send the statement with the notice of the meeting or as soon as practicable after

In either instance, the **requisitionists** bear any costs unless the company resolves otherwise.

Exam focus point

> The right of members to have resolutions included on the agenda of meetings is often asked in law assessments. It is an **important consideration if some of the members disagree with the directors**.

4.5 Content of notices

FAST FORWARD

> The **notice** convening the meeting must give certain details: the **date**, **time** and **place** of the meeting and identification of AGM and special resolutions. Sufficient information about business to be discussed at the meeting should be provided to enable shareholders to know what is to be done.

The notice of a general meeting must contain adequate information on the following points.

(a) The **date**, **time** and **place** of the meeting must be given.

(b) An **AGM** or a **special resolution** must be described as such.

(c) Information must be given of the business of the meeting **sufficient** to enable members (in deciding whether to attend or to appoint proxies) to **understand what will be done** at the meeting.

4.5.1 Routine business

In issuing the notice of an AGM it is standard practice merely to list the **items of ordinary or routine business** to be transacted, such as the following.

- Declaration of dividends (if any)
- Election of directors
- Appointment of auditors and fixing of their remuneration

The articles usually include a requirement that members shall be informed of any intention to **propose** the **election** of a director, other than an existing director who retires by rotation and merely stands for re-election.

Question

Removal of a director

How can members remove a director from office? What is special notice in this context?

Answer

A company may by ordinary resolution remove any director from office, notwithstanding any provision to the contrary in the articles or in a contract such as a director's service agreement.

However, this procedure requires that special notice shall be given to the company at least 28 days before the meeting of the intention to propose such a resolution. Moreover, the directors are not required to include the resolution in the notice of the meeting unless the person who intends to propose it has a sufficient shareholding.

If a company receives special notice it must send a copy to the director concerned who has the right to have written representations of reasonable length circulated to members. They may also speak before the resolution is put to the vote at the meeting.

Question

When is a public company compelled to call a general meeting?

Answer

Members of a company who hold not less than one tenth of the company's paid up share capital carrying voting rights, or members representing one tenth of the voting rights, may requisition the holding of a general meeting. The directors are then required within 21 days to issue a notice convening the meeting to transact the business specified in the requisition. This must be within 21 days.

An auditor who resigns giving reasons for his resignation may requisition a general meeting so that he may explain to members the circumstances of his resignation.

If the net assets of a public company are reduced to less than half in value of its called-up share capital the directors must convene a general meeting to consider what, if any, steps should be taken.

The court has statutory power in certain circumstances to direct that a meeting shall be held.

5 Proceedings at meetings

5.1 How a meeting proceeds

FAST FORWARD

Company meetings need to be properly run if they are to be **effective** and within the **law**.

A meeting can only reach binding decisions if:

- It has been properly **convened** by notice
- A **quorum is present**.
- A **chairman presides**.
- The **business** is **properly transacted** and **resolutions** are **put to the vote**.

There is no obligation to allow a member to be present if their shares do not carry the right to attend and vote. However, **full general meetings** and **class meetings** can be held when shareholders not entitled to vote are present.

Each **item of business** comprised in the notice should be taken separately, discussed and **put to the vote**.

Members may propose **amendments** to any resolutions proposed. The chairman should reject any amendment which is outside the limits set by the notice convening the meeting.

If the relevant business is an **ordinary resolution** it may be possible to amend the resolution's wording so as to **reduce its effect** to something less (provided that the change does not entirely alter its character). For example an ordinary resolution authorising the directors to borrow £100,000 might be amended to substitute a limit of £50,000 (but not to increase it to £150,000 as £100,000 would have been stated in the notice).

5.2 The chairman

FAST FORWARD

The meeting should usually be chaired by the **chairman** of the board of directors. They do not necessarily have a casting vote.

The articles usually provide that the **chairman** of the board of directors **is to preside** at general meetings; in their absence another director chosen by the directors shall preside instead. In the last resort a member chosen by the members present can preside.

The chairman derives their authority from the articles and they have **no casting vote unless** the **articles give them one**. Their duties are to **maintain order** and to **deal** with the **agenda** in a methodical way so that the business of the meeting may be properly transacted.

The chairman:

- **May dissolve** or **adjourn** the **meeting** if it has become disorderly or if the members present agree.
- Must **adjourn** if the meeting **instructs** them to do so.

5.3 Quorum

FAST FORWARD

The **quorum** for meetings may be two or more (except for single member private companies). **Proxies** can attend, speak and vote on behalf of members.

Key term

A **quorum** is the minimum number of persons required to be present at a particular type of (company) meeting. In the case of shareholders' meetings, the figure is usually two, in person or by proxy, but the articles may make other provisions.

There is a legal principle that a 'meeting means a coming together of more than one person'. Hence it follows that as a matter of law **one person generally cannot be a meeting.**

The rule that at least two persons must be present to constitute a 'meeting' does not require that both persons must be members. Every member has a **statutory right to appoint a proxy** to attend as their representative.

In theory, **ultimate control** over a company's business lies with the **members** in a **general meeting**. One would obviously conclude that a meeting involved more than one person, and indeed there is authority to that effect in *Sharp v Dawes 1876.* In this case a meeting between a lone member and the company secretary was held not to be validly constituted. It is possible, however, for a meeting of only one person to take place and we shall consider this shortly.

5.3.1 Proxies

Key term

A **proxy** is a person appointed by a shareholder to vote on behalf of that shareholder at company meetings.

Any member of a company which has a share capital, provided they are entitled to attend and vote at a general or class meeting of the company, has a statutory right (s 324) to appoint an **agent**, called a **'proxy'**, to attend and vote for them.

Rules for appointing proxies	
Basic rule	• Any **member** may appoint a proxy • The proxy **does not** have to be a member • Proxies **may speak** at the meeting • A member may **appoint more than one proxy** provided each proxy is appointed in respect of a different class of share held by the member.
Voting	• Proxies **may vote** on **poll** and on a **show of hands** • Proxies may **demand a poll** at a meeting • Most companies provide **two-way proxy cards** that the member can use to instruct a proxy how to vote, either for or against a resolution.
Notice	• Every notice of a meeting must **state** the member's right to a proxy • **Notice** of a proxy appointment should be given to the company at least 48 hours before the meeting (excluding weekends and bank holidays)

Hence one member and another member's proxy may together provide the quorum (if it is fixed, as is usual, at 'two members present in person or by proxy'). However one member who is also the proxy appointed by another member cannot by themself be a meeting, since a **minimum of two individuals** present is required.

There may, however, be a meeting attended by one person only, if:

(a) It is a **class meeting** and all the **shares** of that class are **held** by **one member.**

(b) The **court**, in exercising a power to order a general meeting to be held, **fixes** the **quorum** at one. This means that in a two-member company, a meeting can be held with one person if the other deliberately absents themself to frustrate business.

(c) The company is a **single member private company**.

The articles usually fix a **quorum** for general meetings which may be as low as two (the minimum for a meeting) but may be more – though this is unusual.

If the articles do fix a quorum of two or more persons present, the meeting lacks a quorum (it is said to be an 'inquorate' meeting) if either:

- The **required number** is **not present** within a **stipulated time** (usually half an hour) of the appointed time for commencing a meeting.
- The **meeting begins** with a **quorum** but the **number present dwindles** to less than the quorum – unless the articles provide for this possibility.

The articles usually provide for automatic and compulsory **adjournment of an inquorate meeting** and can provide that a meeting which begins with a quorum, may continue despite a reduction in numbers present to less than the quorum level. However, there must still be **two or more persons present**.

5.4 Voting and polls

FAST FORWARD

Voting at general meetings may be on a **show of hands** or a **poll**.

The **rights of members** to **vote** and the **number of votes** to which they are entitled in respect of their shares are fixed by the **articles**.

One vote per share is normal but some shares, for instance preference shares, may carry no voting rights in normal circumstances. To shorten the proceedings at meetings the procedure is as follows.

5.4.1 Voting on a show of hands

Key term

A **show of hands** is a method of voting for or against a resolution by raising hands. Under this method each member has one vote irrespective of the number of shares held, in contrast to a poll vote.

On putting a resolution to the vote the chairman calls for a show of hands. One vote may be given by each member present in person, including proxies.

Unless a poll is then demanded, the chairman's declaration of the result is **conclusive**. However it is still possible to challenge the chairman's declaration on the grounds that it was fraudulent or manifestly wrong.

5.4.2 Voting on a poll

Key term

A **poll** is a method of voting at company meetings which allows a member to use as many votes as their shareholding grants them.

If a **real test of voting strength** is required a poll may be demanded. The result of the previous show of hands is then disregarded. On a poll every member and also proxies representing absent members may cast the full number of votes to which they are entitled. A poll need not be held at the time but may be postponed so that arrangements to hold it can be made.

A poll may be **demanded** by:

- Not **less than five members**
- Member(s) **representing** not less than **one tenth** of the **total voting rights**
- Member(s) **holding shares** which **represent** not less than **one tenth** of the **paid-up capital**

Any provision in the articles is **void** if it seeks to prevent such members demanding a poll or to exclude the right to demand a poll on any question other than the election of a chairman by the meeting or an adjournment.

When a poll is held it is usual to appoint **'scrutineers'** and to ask members and proxies to sign voting cards or lists. The votes cast are checked against the register of members and the chairman declares the result.

Members of a quoted company may require the directors to obtain an **independent report** in respect of a poll taken, or to be taken, at a general meeting if:

- They represent at least 5% of the voting rights, or
- Are at least 100 in number holding at least £100 of paid up capital.

5.4.3 Result of a vote

In voting, either by show of hands or on a poll, the **number of votes cast determines the result**. Votes which are not cast, whether the member who does not use them is present or absent, are simply disregarded. Hence the majority vote may be much less than half (or three quarters) of the total votes which could be cast.

Results of quoted company polls of must be made available on a **website**. The following information should be made available as soon as **reasonably practicable**, and should remain on the website for at least **two years**.

- Meeting date
- Text of the resolution or description of the poll's subject matter
- Number of votes for and against the resolution

5.5 Minutes of company meetings

FAST FORWARD

Minutes must be kept of all **general, directors'** and **management meetings**, and members can inspect those of general meetings.

Key term

Minutes are a record of the proceedings of meetings. Company law requires minutes to be kept of all company meetings including general, directors' and managers' meetings.

Every company is **required to keep minutes** which are a formal written record of the proceedings of its general meetings for ten years: s 355. These minutes are usually kept in **book form**. If a loose-leaf book is used to facilitate typing there should be safeguards against falsification, such as sequential prenumbering.

The chairman **normally signs** the minutes. If he does so, the signed minutes are admissible evidence of the proceedings, though evidence may be given to contradict or supplement the minutes or to show that no meeting at all took place.

Members of the company have the **right to inspect** minutes of general meetings. The minutes of general meetings must be held at the registered office (or other permitted location) available for inspection by members, who are also entitled to demand copies.

5.6 The assent principle

A unanimous decision of the members is often treated as a substitute for a formal decision in general meeting properly convened and held, and is equally binding.

6 Class meetings

FAST FORWARD

Class meetings are held where the interests of different groups of shareholders may be affected in different ways.

6.1 Types of class meeting

Class meetings are of two kinds.

(a) If the company has more than one class of share, for example if it has 'preference' and 'ordinary' shares, it may be necessary to call a meeting of the holders of one class of shares, to approve a proposed **variation** of the **rights** attached to their shares.

(b) Under a **compromise** or **arrangement with creditors** (s 895), the holders of shares of the same class may nonetheless be divided into **separate** classes if the scheme proposed will affect each group differently.

When separate meetings of a class of members are held, the same procedural rules as for general meetings apply (but there is a different rule on quorum).

6.2 Quorum for a class meeting

The standard general meeting rules, on issuing notices and on voting, apply to a class meeting.

However the **quorum** for a class meeting is fixed at two persons who hold, or represent by proxy, at least **one third** in nominal value of the issued shares of the class (unless the class only consists of a single member).

If no quorum is present, the meeting is **adjourned** (under the standard adjournment procedure for general meetings). When the meeting resumes, the quorum is **one** person (who must still hold at least one third of the shares).

7 Single member private companies

FAST FORWARD

There are **special rules** for **private companies** with only **one shareholder.**

If the sole member takes any decision that could have been taken in general meeting, that member shall (unless it is a written resolution) provide the company with a **written record** of it. This allows the sole member to conduct members' business informally without notice or minutes.

Filing requirements still apply, for example, in the case of alteration of articles.

Written resolutions **cannot** be used to remove a director or auditor from office as these resolutions require special notice.

Chapter Roundup

- Although the management of a company is in the hands of the directors, the **decisions which affect the existence of the company**, its structure and scope are **reserved to the members** in general meeting.
- There are two kinds of general meeting of members of a company:
  - **Annual general meeting (AGM)**
  - **General meetings at other times**
- A meeting can pass two types of resolution. **Ordinary resolutions** are carried by a simple majority (more than 50%) of votes cast and requiring 14 days' notice. **Special resolutions** require a 75% majority of votes cast and also 14 days' notice.
- A private company can pass any decision needed by a **written resolution**, except for removing a director or auditor before their term of office has expired.
- A meeting cannot make valid and binding decisions until it has been properly convened. Notice of general meetings must be given **14 days** in advance of the meeting. The notice should contain adequate information about the meeting.
- Meetings must be called by a **competent person** or authority.
- **Clear notice** must be given to members. **Notice** must be **sent to all members** entitled to receive it.
- **Special notice of 28 days** of intention to propose certain resolutions (removal of directors/auditors) must be given.
- **Members** rather than directors may be able to requisition resolutions. This may be achieved by requesting the directors call a meeting, or proposing a resolution to be voted on at a meeting already arranged.
- The **notice** convening the meeting must give certain details: the **date**, **time** and **place** of the meeting and identification of AGM and special resolutions. Sufficient information about business to be discussed at the meeting should be provided to enable shareholders to know what is to be done.
- Company meetings need to be properly run if they are to be **effective** and within the **law**.
- The meeting should usually be chaired by the **chairman** of the board of directors. They do not necessarily have a casting vote.
- The **quorum** for meetings may be two or more (except for single member private companies). **Proxies** can attend, speak and vote on behalf of members.
- Voting at general meetings may be on a **show of hands** or a **poll**.
- **Minutes** must be kept of all **general, directors'** and **management meetings**, and members can inspect those of general meetings.
- **Class meetings** are held where the interests of different groups of shareholders may be affected in different ways.
- There are **special rules** for **private companies** with only **one shareholder**.

Quick Quiz

1 Which of the following decisions can only be taken by the members in general meeting?

A Alteration of articles
B Change of name
C Reduction of capital
D Appointment of a managing director

2 Before a private company can hold a general meeting on short notice, members holding a certain percentage of the company's shares must agree. Which one of the following percentages is correct?

51%	90%
75%	95%

3 Plcs must hold their AGM within six months of their year end.

True ☐

False ☐

4 Which of the following matters is a quoted company not legally required to make available on a website?

A Notice of all its general meetings

B Text of resolutions voted on in a poll

C The number of proxies voting for and against a resolution

D The number of votes cast for and against a resolution

5 A member of a public company may only appoint one proxy, but the proxy has a statutory right to speak at the meeting.

True ☐

False ☐

Answers to Quick Quiz

1 A, B and C. The board can appoint someone to be managing director, so D is incorrect.

2 90%

3 True. Plcs must hold their AGM within six months of their year end.

4 C. The number of proxies voting for and against a resolution is not legally required to be made available on a website. Notice of meetings, text of resolutions and the total number of votes cast for and against the resolution are required.

5 False. Public company members can appoint more than one proxy. They have a statutory right to speak.

Now try the question below from the Exam Question Bank

Number	Level	Marks	Time
Q18	Examination	10	18 mins

PART G

Legal implications relating to companies in difficulty or in crisis

17

Insolvency and administration

Topic list	Syllabus reference
1 What is liquidation?	G1(a), G1(b)
2 Voluntary liquidation	G1(a)
3 Compulsory liquidation	G1(b)
4 Differences between compulsory and voluntary liquidation	G1(a), G1(b)
5 Saving a company: administration	G2(a)
6 UNCITRAL Model Law on Cross-Border Insolvency	G1(c)
7 Saving a company: Chapter 11	G2(b)
8 Other national models	G2(a), G1(b)

Introduction

A **company in difficulty** or **in crisis** (an **insolvent** company) basically has a choice of two alternatives:

(1) To continue the business, using statutory methods to help remedy the situation

(2) To stop

A company which is heading towards insolvency can often be **saved**, using a variety of **legal protections** from creditors until the problem is sorted out. As we shall see in Chapter 19, the **directors** of a company can get into a lot of trouble if they carry on trading through a company in serious financial difficulties, and their actions result in **creditors** being **defrauded**.

However, alternative 1 does not have to mean carrying on as if everything is normal. It can mean **seeking help** from the **court** or a **qualified insolvency practitioner** to put a plan together to **save the company** and get it out of its bad financial position.

Unfortunately, many companies cannot be saved, and the members and directors are forced to take alternative 2, **to stop** operating the business through the company. Liquidation, sometimes called 'winding up', is **when a company is formally dissolved** and ceases to exist.

Various methods of achieving liquidation are covered in the first two sections of this chapter. Note though that a company **does not have to be in financial difficulty to be liquidated**.

In an international context, the insolvency of debtors and creditors spread around the world poses particular problems. The UNCITRAL Model Law on Cross-Border Insolvency is designed to help sort out such problems.

Study guide

		Intellectual level
G	**Legal implications relating to companies in difficulty or in crisis**	
1	**Insolvency**	
(a)	Explain the meaning of and procedure involved in voluntary liquidation	2
(b)	Explain the meaning of and procedure involved in compulsory liquidation	2
(c)	Explain and apply the rules in the 1997 UNCITRAL Model Law on Cross-Border Insolvency	2
2	**Alternatives to winding up**	
(a)	Explain administration as an alternative to winding up	2
(b)	Compare administration and Chapter 11 protection	2

Exam guide

As well as being examined in knowledge questions, you may find that elements of insolvency creep into scenario questions on company finances and directors. Be prepared to explain the various methods of closing a business down and how they are investigated.

Statutory references in this chapter are to the Insolvency Act 1986 (as amended by the Insolvency Act 1994 and the Insolvency Act 2000) unless stated otherwise.

1 What is liquidation?

FAST FORWARD

Liquidation is the **dissolution** or **'winding up'** of a company.

Key term

Liquidation means that the company must be dissolved and its affairs 'wound up', or brought to an end.

The assets are realised, debts are paid out of the proceeds, and any surplus amounts are returned to members. Liquidation leads on to **dissolution** of the company. It is sometimes referred to as **winding up**.

1.1 Who decides to liquidate?

FAST FORWARD

There are three different methods of **liquidation; compulsory**, **members' voluntary** and **creditors' voluntary**. Compulsory liquidation and creditors' voluntary liquidation are proceedings for insolvent companies, and members' voluntary liquidation is for solvent companies.

The parties most likely to be involved in the decision to liquidate are:

- The directors
- The creditors
- The members

The **directors** are best placed to know the financial position and difficulty that the company is in. The **creditors** may become aware that the company is in financial difficulty when their invoices do not get paid on a timely basis, or at all.

The **members** are likely to be the last people to know that the company is in financial difficulty, as they rely on the directors to tell them. In public companies, there is a rule that the directors must call a general meeting of members if the net assets of the company fall to half or less of the amount of its called-up share capital. There is no such rule for private companies.

As we shall see in the next two sections, there are three methods of winding up. They depend on **who has instigated the proceedings**. Directors cannot formally instigate proceedings for winding up, they can only make recommendations to the members.

However, if the **members refuse** to put the company in liquidation and the directors feel that to continue to trade will prejudice creditors, they could resign their posts. This prevents them from committing the offences we shall see in Chapter 19.

In any case, if the company was in such serious financial difficulty for this to be an issue, it is likely that a **creditor** would have commenced proceedings against it.

1.1.1 Creditors

If a creditor has grounds (we shall discuss these in Section 2) they may **apply to the court** for the **compulsory winding up** of the company.

Creditors may also be closely involved in a **voluntary winding up**, if the company is **insolvent** when the **members** decide to wind the company up.

1.1.2 Members

The members may decide to wind the company up (probably on the advice of the directors). If they do so, the company is **voluntarily wound up**. This can lead to two different types of members' winding up:

- Members' voluntary winding up (if the company is solvent)
- Creditors' voluntary winding up (if the company is insolvent)

1.2 Role of the liquidator

FAST FORWARD

A **liquidator** must be an authorised, qualified insolvency practitioner.

Once the decision to liquidate has been taken, the company goes into the **control of a liquidator**, who must be a **qualified** and **authorised** insolvency practitioner.

We shall look at the procedures that the liquidator carries out in the next two sections. However, the liquidator also has a statutory duty to **report** to the Secretary of State where he feels that any **director** of the insolvent company is **unfit** to be involved in the management of a company.

1.3 Common features of liquidations

FAST FORWARD

Once **insolvency procedures** have commenced, share trading must cease, the company documents must state that the company is in liquidation and the directors' power to manage ceases.

Regardless of what method of liquidation is used, similar **legal problems** may arise in each of them. In addition, the following factors are true at the start of any liquidation:

- **No share dealings** or **changes in members** are allowed
- All company documents (eg invoices, letters, emails) and the website must **state the company is in liquidation**
- The **directors' power to manage ceases**

2 Voluntary liquidation

FAST FORWARD

A **winding up** is **voluntary** where the decision to wind up is taken by the company's members, although if the company is insolvent, the creditors will be heavily involved in the proceedings.

As we discussed in Section 1, there are two types of voluntary liquidation:

- A **members' voluntary winding up**, where the company is **solvent** and the members merely decide to 'kill it off'
- A **creditors' voluntary winding up**, where the company is **insolvent** and the members resolve to wind up in consultation with creditors

The main differences between a members' and a creditors' voluntary winding up are set out below.

Function	Winding up	
	Members' voluntary	**Creditors' voluntary**
(1) Appointment of liquidator	By members	Normally by creditors though responsible to both members and creditors
(2) Approval for liquidator's actions	General meeting of members	Liquidation committee
(3) Liquidation committee	None	Up to 5 representatives of creditors and 5 representatives of members

The effect of the voluntary winding up being a creditors' one is that the **creditors** have a **decisive influence** on the conduct of the liquidation.

Meetings in a creditors' voluntary winding up are held in the same sequence as in a members' voluntary winding up, but meetings of creditors are called at the same intervals as the meetings of members and for similar purposes.

In both kinds of voluntary winding up, the **court has the power to appoint a liquidator** (if for some reason there is none acting) or to remove one liquidator and appoint another: s 108.

2.1 Members' voluntary liquidation

FAST FORWARD

In order to be a members' winding up, the directors must make a **declaration of solvency**. It is a criminal offence to make a declaration of solvency without reasonable grounds.

Type of resolution to be passed	
Ordinary	This is **rare, but** if the **articles** specify liquidation at a certain point, only an ordinary resolution is required
Special	A company may resolve to be **wound up** by special resolution

The winding up **commences** on the passing of the resolution. A signed copy of the resolution must be delivered to the Registrar within 15 days. A **liquidator** is usually appointed by the same resolution (or a second resolution passed at the same time).

2.1.1 Declaration of solvency

A voluntary winding up is a members' voluntary winding up **only** if the directors make and deliver to the Registrar a **declaration of solvency**: s 89.

This is a **statutory declaration** that the directors have made full enquiry into the affairs of the company and are of the opinion that it will be able to pay its debts in full, within a specified period not exceeding 12 months.

(a) The declaration is made by all the directors or, if there are more than two directors, by a **majority** of them.

(b) The declaration includes a statement of the company's assets and liabilities as at the latest practicable date before the declaration is made.

(c) The declaration must be:

  (i) Made not more than five weeks before the resolution to wind up is passed, and
  (ii) Delivered to the Registrar within 15 days after the meeting.

If the liquidator later concludes that the company will be unable to pay its debts they must call a meeting of creditors and lay before them a **statement of assets and liabilities**: s 95.

Exam focus point

It is a **criminal offence** punishable by fine or imprisonment for a director to make a declaration of solvency without having **reasonable grounds** for it. If the company proves to be insolvent they will have to justify their previous declaration or be punished.

In a members' voluntary winding up the **creditors play no part** since the assumption is that their debts will be paid in full. The liquidator calls special and annual general meetings of contributories (members) to whom they report:

(a) Within three months after each anniversary of the commencement of the winding up the liquidator must call a meeting and lay before it an account of his transactions during the year.

(b) When the liquidation is complete the liquidator calls a meeting to lay before it his final accounts.

After holding the final meeting the liquidator sends a **copy of his accounts** to the Registrar who dissolves the company three months later by removing its name from the register: s 201.

2.2 Creditors' voluntary liquidation

FAST FORWARD

When there is no declaration of solvency there is a **creditors' voluntary winding** up.

If no declaration of solvency is made and delivered to the Registrar the liquidation proceeds as a creditors' voluntary winding up **even if** in the end the company pays its debts in full.

To commence a creditors' voluntary winding up the directors convene a general meeting of members to pass a **special resolution** (private companies may pass a written resolution with a 75% majority). They must also convene a meeting of creditors, giving at least seven days notice of this meeting. The notice must be advertised in the **Gazette** and two local newspapers. The notice must either:

- Give the name and address of a **qualified insolvency practitioner** to whom the creditors can apply before the meeting for information about the company, **or**
- State a place in the locality of the company's principal place of business where, on the two business days before the meeting, a **list of creditors** can be inspected.

The **meeting of members** is held first and its business is as follows:

- To resolve to wind up
- To appoint a liquidator, and
- To nominate up to five representatives to be members of the liquidation committee.

The **creditors' meeting** should preferably be convened on the same day but at a later time than the members' meeting, or on the next day, but in any event within 14 days of it.

One of the **directors** presides at the creditors' meeting and lays before it a full statement of the company's affairs and a list of creditors with the amounts owing to them. The meeting may nominate a liquidator and up to five representatives to be members of the liquidation committee.

If the creditors nominate a different person to be liquidator, **their choice prevails** over the nomination by the members.

Of course, the creditors may decide **not to appoint a liquidator** at all. They cannot be compelled to appoint a liquidator, and if they do fail to appoint one it will be the members' nominee who will take office.

However even if creditors do appoint a liquidator there is a period of up to two weeks before the creditors' meeting takes place at which they will actually make the **appointment**. In the interim it will be the members' nominee who takes office as liquidator.

In either case the presence of the members' nominee as liquidator has been exploited in the past for the purpose known as **'centrebinding'**.

> *Re Centrebind Ltd 1966*
>
> *The facts:* The directors convened a general meeting, without making a statutory declaration of solvency, but failed to call a creditors' meeting for the same or the next day. The penalty for this was merely a small default fine. The liquidator chosen by the members had disposed of the assets before the creditors could appoint a liquidator. The creditors' liquidator challenged the sale of the assets (at a low price) as invalid.
>
> *Decision:* The first liquidator had been in office when he made the sale and so it was a valid exercise of the normal power of sale.

In a 'centrebinding' transaction the assets are sold by an **obliging liquidator** to a new company formed by the members of the insolvent company. The purpose is to defeat the claims of the creditors at minimum cost and enable the same people to continue in business until the next insolvency supervenes.

The Government has sought to limit the abuses during the period between the members' and creditors' meetings. The **powers of the members' nominee as liquidator are now restricted** to:

- Taking control of the company's property,
- Disposing of perishable or other goods which might diminish in value if not disposed of immediately, and
- Doing all other things necessary for the protection of the company's assets.

If the members' liquidator wishes to perform any act other than those listed above, he will have to **apply to the court for leave**.

Question

Voluntary liquidation

What are the key differences between a creditors' voluntary liquidation and a members' voluntary liquidation?

Answer

Creditors' voluntary liquidation	Members' voluntary liquidation
Company is insolvent	Company is solvent
Creditors (usually) appoint liquidator	Members appoint liquidator
Liquidation committee approve liquidator's action	Members approve liquidator's actions in general meeting

3 Compulsory liquidation

FAST FORWARD

A creditor may apply to the court to wind up the company, primarily if the company is **unable to pay its debts**. There are statutory tests to prove that a company is unable to pay its debts.

A **creditor** may apply to the court for a compulsory winding up. There are seven statutory reasons he can give, which can all be found in s122. We shall consider the two most important here.

	Statutory reasons for compulsory liquidation
s122(1)(f)	Company is unable to pay its debts
s122(1)(g)	It is just and equitable to wind up the company

The **Government** may petition for the compulsory winding up of a company:

- If a public company has not obtained a, **trading certificate** within one year of incorporation
- Following a report by Government inspectors that it is in the **public interest** and **just and equitable** for the company to be wound up

3.1 Company unable to pay its debts

A creditor who petitions on the grounds of the company's insolvency must show that the company is unable to pay its debts. There are three permitted ways to do that: s 123.

(a) A **creditor owed more than £750 serves** the company at its registered office a **written demand** for payment and the **company neglects** to **pay the debt** or to offer reasonable security for it within 21 days.

If the company denies it owes the amount demanded on apparently reasonable grounds, the court will dismiss the petition and leave the creditor to take legal proceedings for debt.

(b) A creditor obtains **judgement** against the company for debt, and attempts to enforce the judgement. However, they are **unable to obtain payment**, because no assets of the company have been found and seized.

(c) A creditor satisfies the court that, taking into account the contingent and prospective liabilities of the company, it is **unable to pay its debts**. The creditor may be able to show this in one of two ways:

(i) By proof that the company is not able to pay its debts as they fall due – the **commercial insolvency test**

(ii) By proof that the company's assets are less than its liabilities – the **balance sheet test**

This is a residual category. Any suitable evidence of actual or prospective insolvency may be produced.

Exam focus point

In Chapter 13, we outlined that a secured creditor might appoint a receiver to control the secured asset for the purpose of realising the creditors' loan. If the receiver cannot find an asset to realise, the creditor might file a petition for compulsory liquidation under (b).

3.2 The just and equitable ground

FAST FORWARD

A **dissatisfied member** may get the court to wind the company up on the **just and equitable ground**.

A member who is dissatisfied with the directors or controlling shareholders over the management of the company may petition the court for the company to be wound up on the **just and equitable ground**.

For such a petition to be successful, the member must show that **no** other remedy is available. It is not enough for a member to be **dissatisfied** to make it just and equitable that the company should be wound up, since winding up what may be an otherwise healthy company is a **drastic step**.

3.2.1 Examples: When companies have been wound up

(a) **The substratum of the company has gone – the only or main object(s) of the company (its underlying basis or substratum) cannot be or can no longer be achieved.**

> *Re German Date Coffee Co 1882*
>
> *The facts:* The objects clause specified very pointedly that the sole object was to manufacture coffee from dates under a German patent. The German government refused to grant a patent. The company manufactured coffee under a Swedish patent for sale in Germany. A member petitioned for compulsory winding up.
>
> *Decision:* The company existed only to 'work a particular patent' and as it could not do so it should be wound up.

(b) **The company was formed for an illegal or fraudulent purpose or there is a complete deadlock in the management of its affairs.**

> *Re Yenidje Tobacco Co Ltd 1916*
>
> *The facts:* Two sole traders merged their businesses in a company of which they were the only directors and shareholders. They quarrelled bitterly and one sued the other for fraud. Meanwhile they refused to speak to each other and conducted board meetings by passing notes through the hands of the secretary. The defendant in the fraud action petitioned for compulsory winding up.
>
> *Decision:* 'In substance these two people are really partners' and by analogy with the law of partnership (which permits dissolution if the partners are really unable to work together) it was just and equitable to order liquidation.

(c) **The understandings between members or directors which were the basis of the association have been unfairly breached by lawful action.**

> *Ebrahimi v Westbourne Galleries Ltd 1973*
>
> *The facts:* E and N carried on business together for 25 years, originally as partners and for the last 10 years through a company in which each originally had 500 shares. E and N were the first directors and shared the profits as directors' remuneration; no dividends were paid. When N's son joined the business he became a third director and E and N each transferred 100 shares to N's son. Eventually there were disputes. N and his son used their voting control in general meeting (600 votes against 400) to remove E from his directorship under the power of removal given by what is now s 168 of the Companies Act 2006 (removal by ordinary resolution).
>
> *Decision:* The company should be wound up. N and his son were within their legal rights in removing E from his directorship, but the past relationship made it 'unjust or inequitable' to insist on legal rights and the court could intervene on equitable principles to order liquidation.

Re A company 1983

The facts: The facts were similar in essentials to those in *Ebrahimi's case* but the majority offered and the petitioner agreed that they would settle the dispute by a sale of his shares to the majority. This settlement broke down however because they could not agree on the price. The petitioner then petitioned on the just and equitable ground.

Decision: An order for liquidation on this ground may only be made 'in the absence of any other remedy'. As the parties had agreed in principle that there was an alternative to liquidation the petition must be dismissed.

3.3 Proceedings for compulsory liquidation

When a petition is presented to the **court** a copy is delivered to the **company** in case it objects. It is advertised so that other creditors may intervene if they wish.

The petition **may** be presented by a member. If the petition is presented by **a member** he **must show** that:

(a) The company is **solvent** or alternatively refuses to supply information of its financial position, and

(b) He has been a **registered shareholder** for at least 6 of the 18 months up to the date of his petition. However this rule is not applied if the petitioner acquired his shares by allotment direct from the company or by inheritance from a deceased member or if the petition is based on the number of members having fallen below two.

Attention!

The court will not order compulsory liquidation on a member's petition if he has nothing to gain from it. If the company is insolvent he would receive nothing since the creditors will take all the assets.

Once the court has been petitioned, a **provisional liquidator** may be appointed by the **court**. The **official receiver** is usually appointed, and his powers are conferred by the court. These usually extend to taking control of the company's property and applying for a special manager to be appointed.

Key term

The **official receiver** is an officer of the court. They are appointed as liquidator of any company ordered to be wound up by the court, although an insolvency practitioner may replace them.

3.4 Effects of an order for compulsory liquidation

The effects of an **order** for compulsory liquidation are:

(a) The **official receiver** (an official of the Government whose duties relate mainly to bankruptcy of individuals) **becomes liquidator**: s 136.

(b) The liquidation is **deemed to have commenced at the time** (possibly several months earlier) **when the petition was first presented**.

(c) Any **disposition** of the **company's property** and any transfer of its shares subsequent to the commencement of liquidation is **void** unless the court orders otherwise: s 127.

(d) Any **legal proceedings** in progress against the company are halted (and none may thereafter begin) unless the court gives leave. Any seizure of the company's assets after commencement of liquidation is void: ss 130 and 128.

(e) The **employees** of the company are **automatically dismissed**. The liquidator assumes the powers of management previously held by the directors.

(f) Any **floating charge crystallises**.

The assets of the company may remain the company's legal property but **under the liquidator's control** unless the court by order **vests** the assets in the liquidator. The business of the company may continue but it is the liquidator's duty to continue it with a view only to realisation, for instance by sale as a going concern.

Within 21 days of the making of the order for winding up a **statement of affairs** must be delivered to the liquidator verified by one or more directors and by the secretary (and possibly by other persons). The statement shows the assets and liabilities of the company and includes a list of creditors with particulars of any security: s 131.

The liquidator may require that any **officers or employees** concerned in the recent management of the company shall join in submitting the statement of affairs.

3.4.1 Investigations by the official receiver

The official receiver **must investigate** (s 132)

- The **causes of the failure** of the company, and
- Generally the **promotion**, **formation**, **business dealings** and **affairs** of the company.

The official receiver **may report** to the court on the results.

(a) The official receiver may require the **public examination** in open court of those believed to be implicated (a much-feared sanction).

(b) The official receiver may apply to the court for public examination where half the **creditors** or three-quarters of the **shareholders** (in value in either case) so request. Failure to attend, or reasonable suspicion that the examinees will abscond, may lead to arrest and detention in custody for contempt of court.

3.4.2 Meetings of contributories and creditors

Key term

> **Contributories** are **members** of a company.
>
> At winding up, the member may have to make payments to the company in respect of any unpaid share capital or guarantees (see Chapter 12).

The official receiver has 12 weeks to decide whether or not to convene **separate meetings** of creditors and contributories. The meetings provide the creditors and contributories with the opportunity to appoint their own nominee as permanent liquidator to replace the official receiver, and a **liquidation committee** to work with the liquidator.

If the official receiver believes there is little interest and that the creditors will be unlikely to appoint a liquidator he can **dispense with a meeting**, informing the court, the creditors and the contributories of the decision. He can always be required to call a meeting if at least 25 per cent in value of the creditors require him to do so: s 136.

If no meeting is held, or one is held but no liquidator is appointed, the official receiver continues to act as liquidator. If the creditors do hold a meeting and **appoint their own nominee** this person automatically becomes liquidator subject to a right of objection to the court. Any person appointed to act as liquidator must be a qualified insolvency practitioner.

At any time after a winding up order is made, **the official receiver may ask the Secretary of State to appoint a liquidator**. Similarly, he may request an appointment if the creditors and members fail to appoint a liquidator: s 137.

If separate meetings of creditors and contributories are held and different persons are nominated as liquidators, it is the **creditors' nominee** who **takes precedence**.

Notice of the order for compulsory liquidation and of the appointment of a liquidator is given to the Registrar and in the *Gazette*.

If, while the liquidation is in progress, the liquidator decides to call meetings of contributories or creditors he may arrange to do so under powers vested in the court.

3.5 Completion of compulsory liquidation

When the liquidator completes his task he reports to the Government, which **examines his accounts**. He may apply to the court for an order for dissolution of the company.

An official receiver may also apply to the Registrar for an **early dissolution** of the company if its realisable assets will not cover his expenses and further investigation is not required: s 202.

Question

Compulsory liquidation order

What are the six effects of a compulsory liquidation order?

Answer

- Official receiver appointed as liquidator
- Liquidation deemed to have commenced at time when petition first presented
- Disposition of company property since commencement of liquidation deemed void
- Legal proceedings against the company are halted
- Employees are dismissed
- Any floating charge crystallises

4 Differences between compulsory and voluntary liquidation

FAST FORWARD

The differences between compulsory and voluntary liquidation are associated with **timing**, the **role** of the **official receiver**, **stay of legal proceedings** and the **dismissal of employees**.

The main differences in **legal consequences** between a compulsory and a voluntary liquidation up are as follows.

	Differences
Control	Under a members' voluntary liquidation the members control the liquidation process. Under a creditors' voluntary liquidation the creditors control the process. The court controls the process under a compulsory liquidation.
Timing	A voluntary winding up commences on the day when the **resolution to wind up is passed**. It is not retrospective. A compulsory winding up, once agreed to by the court, commences on the day the **petition was presented**.
Liquidator	The **official receiver** plays **no role** in a **voluntary winding up**. The members or creditors select and appoint the liquidator and he is not an officer of the court.
Legal proceedings	In a voluntary winding up there is no automatic **stay of legal proceedings** against the company, nor are previous dispositions or seizure of its assets void. However the liquidator has a general right to apply to the court to make any order which the court can make in a compulsory liquidation. He would do so, for instance, to prevent any creditor obtaining an unfair advantage over the other creditors.
Management and staff	In any **liquidation the liquidator replaces the directors** in the management of the company (unless he decides to retain them). However, the employees are **not automatically dismissed by commencement of voluntary liquidation**. Insolvent liquidation may amount to repudiation of their employment contracts (provisions of the statutory employment protection code apply).

5 Saving a company: administration

Administration is a method of **'saving' a company from liquidation**, under the Enterprise Act 2002.

5.1 What is administration?

FAST FORWARD

An **administrator** is appointed primarily to try to rescue the company as a going concern. A company may go into administration to carry out an established plan to save the company.

Key term

Administration puts an **insolvency practitioner** in **control** of the company with a defined programme for **rescuing the company** from insolvency as a going concern.

Its purpose is to **insulate** the company **from its creditors while it seeks:**

- To save itself as a going concern, or failing that
- To achieve a better result for creditors than an immediate winding up would secure, or failing that
- To realise property so as to make a distribution to creditors.

Administration orders and liquidations are **mutually exclusive**. Once an administration order has been passed by the court, it is **no longer possible to petition the court** for a **winding up** order against the company. Similarly, however, once an order for winding up has been made, an administration order cannot be granted (except when appointed by a floating chargeholder, see Section 5.2).

Administration can be initiated with or without a court order.

5.2 Appointment without a court order

FAST FORWARD

Some parties – **secured creditors** and **directors** and the **members** by resolution – can appoint an administrator without a court order.

It is possible to appoint an administrator **without reference to the court**. There are three sets of people who might be able to do this:

- Floating chargeholders
- Directors
- Company

Attention!

Floating chargeholders were introduced in Chapter 13. Revise them now if you are not sure.

5.2.1 Floating chargeholders

Floating chargeholders have the right to appoint an administrator without reference to the court even if there is no actual or impending insolvency. They may also **appoint an administrator even if the company is in compulsory liquidation**. This enables steps to be taken to save the company before its financial situation becomes irreversible.

In order to qualify for this right, the **floating charge must entitle the holder to appoint an administrator**. This would be in the terms of the charge. It must also be over all, or substantially all, the company's property.

Point to note

In practice, such a floating chargeholder with a charge over all or substantially all the company's property is likely to be a **bank**.

However, the **floating chargeholder may only appoint an administrator** if:

- They have given **two days** written notice to the holder of any prior floating charge where that person has the right to appoint an administrator
- Their floating charge is **enforceable**

After any relevant two day notice period (see above), the floating chargeholder will file the following **documents** at court:

- A **notice of appointment** in the prescribed form identifying the administrator
- A **statement by the administrator** that he **consents to the appointment**
- A **statement by the administrator** that, in his **opinion**, the **purpose of the administration** is likely to be **achieved**
- A **statutory declaration** that he **qualifies** to make the appointment

Once these documents have been filed, the **appointment is valid**. The appointer must notify the administrator and other people prescribed by regulations of the appointment as soon as is reasonably practicable.

5.2.2 Company and directors

The process by which a company commences appointing an administrator will depend upon its **articles of association**. A company or its directors may appoint an administrator if:

- The company has not done so in the last 12 months or been subject to a **moratorium** as a result of a voluntary arrangement with its creditors in the last 12 months
- The company is, or is likely to be, **unable to pay its debts**
- **No petition for winding up** nor any **administration order** in respect of the company has been presented to the court and is outstanding
- The company is **not in liquidation**
- **No administrator** is already in office
- **No administrative receiver** is already in office

The company or its directors must give notice to any floating chargeholders entitled to appoint an administrator. This means that the **floating chargeholders may** appoint their own administrator within this time period, and so **block the company's choice of administrator**.

5.3 Appointment with a court order

FAST FORWARD

Various parties can apply for **administration** through the court.

There are four sets of parties that may apply to the court for an administration order:

- The **company** (that is, a majority of the members by (ordinary) resolution)
- The **directors** of the company
- One or more **creditors** of the company
- The **Justice** and **Chief Executive of the Magistrates' Court** following non-payment of a fine imposed on the company

Point to note

Individual members **cannot** apply to the court for an administration order.

The court will grant the administration order if it is satisfied that:

- The company is, or is likely to be, **unable to pay its debts**, and
- The administration order is reasonably likely to **achieve the purpose of administration**

The application will name the person whom the applicants want to be the **administrator**. Unless certain interested parties object, this person is appointed as administrator.

5.4 The effects of appointing an administrator

FAST FORWARD

The **effects** of administration depend on whether it is effected by the **court** or by a **floating chargeholder**, to some degree.

Effects of an administrator appointment
A **moratorium** over the company's debts commences (that is, no creditor can enforce their debt during the administration period without the court's permission). This is the advantageous aspect of being in administration.
The court must give its permission for: • **Security** over company property to be **enforced** • Goods held under hire purchase to be **repossessed** • A landlord to conduct **forfeiture** by peaceable entry • Commencement/continuation of any **legal process** against the company
The **powers of management** are subjugated to the authority of the administrator and managers can only act with his consent.
All outstanding **petitions for winding-up** of the company are **dismissed.**
Any **administrative receiver** in place must **vacate office**. No appointments to this position can be made.

5.5 Duties of the administrator

FAST FORWARD

The administrator has **fiduciary duties** to the company as its agent, plus some legal duties.

The administrator is an **agent of the company** and the **creditors as a whole**. He therefore owes fiduciary duties to them and has the following legal duties.

Legal duties of the administrator
As soon as **reasonably practicable** after appointment he must:
• **Send notice** of appointment to the company
• **Publish notice** of appointment
• Obtain a list of **company creditors** and sent notice of appointment to each
• Within 7 days of appointment, send notice of appointment to **Registrar**
• Require certain relevant people to provide a **statement of affairs** of the company
• Ensure that every **business document** of the company **bears the identity** of the administrator and a statement that the affairs, business and property of the company are being managed by him.
• Consider the **statements of affairs** submitted to him and set out his **proposals** for achieving the aim of administration. The proposals must be **sent to the Registrar** and the company's **creditors,** and be made available to **every member of the company** as soon as is reasonably practicable, and **within eight weeks**.
• Whilst preparing their proposals, the administrator must **manage the affairs** of the company.

The **statement of affairs** must be provided by the people from whom it is requested within 11 days of it being requested. It is in a prescribed form, and contains:

- Details of the **company's property**
- The company's **debts** and **liabilities**
- The **names** and **addresses** of the **company's creditors**
- Details of any **security** held by any **creditor**

Failing to provide a statement of affairs, or providing a statement in which the writer has no reasonable belief of truth, is a **criminal offence** punishable by fine.

5.6 Administrator's proposals

FAST FORWARD

The administrator must either **propose a rescue plan**, or state that the **company cannot be rescued**.

Having considered all information the administrator must within 8 weeks (subject to possible extension) either:

- Set out his **proposals for achieving the aim of the administration**; or
- Set out why it is not **reasonable and practicable** that the company be rescued. In this case he will also set out why the creditors as a whole would benefit from winding up.

The proposal must be sent to all members and creditors he is aware of. It must not:

- Affect the right of a **secured creditor** to enforce his security
- Result in a non-preferential debt being paid in priority to a preferential debt
- Result in one preferential creditor being paid a smaller proportion of his debt than another.

5.6.1 Creditors' meeting

The administrator must call a **meeting of creditors** within **10 weeks** of their appointment to approve the proposals. The creditors may either accept or reject them. Once the proposals have been agreed, the administrator cannot make any substantial amendment without first gaining the creditors' consent.

5.7 Administrator's powers

FAST FORWARD

The administrator takes on the **powers** of the directors.

The powers of the administrator are summed up as follows:

> 'The administrator of a company may do **anything necessarily expedient** for the management of the affairs, business and property of the company.'

The administrator **takes on the powers previously enjoyed by the directors** and the following specific powers to:

- Remove or appoint a **director**
- Call a **meeting of members or creditors**
- **Apply to court for directions** regarding the carrying out of his functions
- Make payments to **secured or preferential creditors**
- With the permission of the court, **make payments to unsecured creditors**

The administrator usually requires the permission of the court to make payments to unsecured creditors. However, this is not the case if the administrator feels that paying the unsecured creditor will assist the **achievement of the administration**. For example, if the company has been denied further supplies by a major supplier unless payment is tendered.

Any creditor or member of the company may **apply to the court** if they feel that the administrator has acted or will act in a way that has harmed or will harm his interest. The court may take various actions against the administrator.

5.8 End of administration

FAST FORWARD

Administration can last up to **12 months**.

The administration period **ends** when:

- The administration has been successful
- 12 months have elapsed from the date of the appointment of administrator
- The administrator applies to the court to end the appointment
- A creditor applies to the court to end the appointment
- An improper motive of the applicant for applying for the administration is discovered.

The administrator automatically vacates office after **12 months of his appointment**. This time period can be extended by court order or by consent from the appropriate creditors.

Alternatively, the administrator may **apply to the court** when he thinks:

- The purpose of administration cannot be achieved
- The company should not have entered into administration
- The administration has been successful (if appointed by the court)

He must also apply to the court if required to by the **creditors' meeting**.

Where the administrator was appointed by a chargeholder or the company/its directors, and he feels that the purposes of administration have been achieved, he must file a **notice** with the court and the Registrar.

5.9 Advantages of administration

FAST FORWARD

Administration has been found to have many advantages for the **company**, the **members** and the **creditors**.

Advantages of administration	
To the company	The company does not necessarily cease to exist at the end of the process, whereas liquidation will always result in the company being wound up.
	It provides temporary relief from creditors to allow breathing space to formulate rescue plans.
	It prevents any creditor applying for compulsory liquidation.
	It provides for past transactions to be challenged.
To the members	They will continue to have shares in the company which has not been wound up. If the administration is successful, regenerating the business should enhance share value and will restore any income from the business.
To the creditors	Creditors should obtain a return in relation to their past debts from an administration.
	Unsecured creditors will benefit from asset realisations.
	Any creditor may apply to the court for an administration order, while only certain creditors may apply for other forms of relief from debt. For example, the use of receivers or an application for winding up.
	Floating chargeholders may appoint an administrator without reference to the court.
	It may also be in the interests of the creditors to have a continued business relationship with the company once the business has been turned around.

Exam focus point

You may be asked to consider the advantages of administration as opposed to liquidation from the point of view of all the parties involved.

6 UNCITRAL Model Law on Cross-Border Insolvency

FAST FORWARD

The Model Law allows insolvency proceedings begun in **one jurisdiction** to be recognised, facilitated and co-operated with in other jurisdictions. It has the aim of assisting in the rescue of financially troubled businesses, protecting the assets of insolvent debtors for the benefit of creditors, and maximising their overall value.

6.1 Cross-border insolvency

Key term

> **Cross-border insolvency** occurs when there are insolvency proceedings relating to a single debtor in more than one state, or the debtor has assets in more than one state, or there are creditors in more than one state.

The Model Law on Cross-Border Insolvency, produced by UNCITRAL in 1997, is recommended for incorporation into member states' national laws. In incorporating the text of the Model Law into its system, a state may modify or leave out some of its provisions, but in order to achieve a satisfactory degree of harmonisation and certainty, it is recommended that states make as few changes as possible in incorporating the Model Law into their legal systems.

The **increasing evidence** of cross-border insolvencies reflects the continuing **global expansion of trade and investment**. However, national insolvency laws are often ill-equipped to deal with cases of a cross-border nature. This frequently results in inadequate and inharmonious legal approaches, which:

(a) Hamper the rescue of financially troubled business,
(b) Are not conducive to a fair and efficient administration of cross-border insolvencies,
(c) Impede the protection of the assets of the insolvent debtor against dissipation, and
(d) Hinder maximisation of the value of those assets.

Fraud by insolvent debtors, in particular by concealing assets or transferring them to foreign jurisdictions, is an increasing problem, in terms of both its frequency and its magnitude. The modern, interconnected world makes such fraud easier to conceive and carry out.

6.2 Scope of the Model Law's application

Under Article 1, the Model Law may be applied in a number of cross-border insolvency situations, including the following:

(a) The case of an inward-bound request for recognition of a foreign proceeding;

(b) An outward-bound request from a court or administrator in the enacting state for recognition of an insolvency proceeding commenced under the laws of the enacting state;

(c) Co-ordination of concurrent proceedings in two or more states; and

(d) Participation of foreign creditors in insolvency proceedings taking place in the enacting state.

6.2.1 Types of foreign proceedings covered

To fall within the scope of the Model Law, **foreign insolvency proceeding** needs to have (Article 2):

(a) Basis in insolvency-related law of the originating state;

(b) Involvement of creditors collectively;

(c) Control or supervision of the assets and affairs of the debtor by a court or another official body; and

(d) Reorganisation or liquidation of the debtor as the purpose of the proceeding.

Thus a variety of collective proceedings can be recognised. They may be compulsory or voluntary, corporate or individual, winding-up or reorganisation. It also includes those in which the debtor retains some measure of control over its assets, albeit under court supervision.

Certain types of entities, such as banks or insurance companies specially regulated with regard to insolvency under the laws of the enacting state, are excluded (Article 1).

6.3 Effect of enacting the Model Law

The Model Law seeks to ensure predictability and reliability where insolvency crosses borders.

Enacting the Model Law in the national legislation of one state provides for:

(a) Quick and direct access for foreign representatives to courts
(b) Recognition of foreign insolvency proceedings
(c) Judicial co-operation across borders

6.4 Access for foreign representatives

In addition to establishing the principle of direct cost access for foreign representatives, the Model Law:

(a) Establishes **simplified proof requirements** for seeking recognition and relief for foreign proceedings (Article 15);

(b) Provides **foreign representatives** a procedural standing for commencing an insolvency proceeding in the enacting state and allowing them to participate in an insolvency proceeding in the enacting state (Articles 11 and 12);

(c) Provides **foreign creditors** access to the courts of the enacting state for the purpose of commencing an insolvency proceeding or participating in such a proceeding (Article 13);

(d) Gives the foreign representative the right to **intervene** in proceedings concerning individual actions in the enacting state affecting the debtor or its assets (Article 24);

(e) Provides that the mere fact of a petition for recognition in the enacting state does **not** mean that the courts in that state have jurisdiction over **all the assets and affairs of the debtor** (Article 10).

6.5 Recognition of foreign insolvency proceedings

The Model Law establishes **criteria** for determining whether a foreign proceeding is to be recognised (Articles 15-17). It provides that, in appropriate cases, the court may grant **interim,** urgently needed, **relief** pending a decision on recognition (Article 19). The decision includes determining whether the foreign insolvency proceeding should be recognised as a 'main' or 'non-main' foreign insolvency proceeding. This may affect the nature of the relief accorded to the foreign representative.

It is deemed to be the 'main' proceeding if it has been commenced in the state where 'the debtor has the centre of its main interests'.

6.5.1 Effects of recognition: stay and suspension

Once recognised as a **main proceeding**, the following reliefs may automatically be available to the foreign representative:

(a) A **stay of actions of individual creditors** against the debtor, or
(b) A **stay of enforcement proceedings** concerning the assets of the debtor, and
(c) A **suspension of the debtor's right to transfer or encumber its assets** (Article 20(1)).

These reliefs are necessary to provide 'breathing space' until appropriate measures are taken for reorganisation or fair liquidation of the assets of the debtor. The suspension of transfers is necessary because in modern economic systems it is possible for multinational debtors to move money and property across boundaries quickly. The mandatory moratorium triggered by the recognition of the foreign main proceedings provides a rapid 'freeze'. This is essential to prevent fraud and to protect the legitimate interests of the parties involved until the court has an opportunity to notify all concerned and to assess the situation.

In addition to the mandatory stay and suspension, courts may grant 'discretionary' relief for the benefit of any foreign proceeding, whether it is a 'main' proceeding or not: Article 21. Such discretionary relief may consist of, for example:

(a) Staying proceedings or suspending the right to encumber assets (Article 20),
(b) Facilitating access to information concerning the assets of the debtor and its liabilities,
(c) Appointing a person to administer all or part of those assets.

Urgently needed relief may be granted already upon filing an application for recognition (Article 21).

6.5.2 Protection of creditors and other interested persons

The Model Law contains provisions to protect the interests of the creditors (in particular local creditors), the debtor and other affected persons. Temporary relief upon application for recognition of a foreign proceeding or upon recognition is available. The court must be satisfied that the interests of the creditors and other interested persons, including the debtor, are adequately protected (Article 22(1)). The court may make such conditions it considers appropriate, and may modify or terminate the relief granted, if so requested by a person affected thereby (Article 22 (2) and (3)).

6.6 Co-operation across borders

The Model Law expressly empowers courts to extend co-operation in the areas covered by the Model Law. Article 26 contains provisions authorising co-operation between a courts in the enacting state, foreign representatives, persons administering the insolvency proceeding in the enacting state and a foreign court or a foreign representative.

Possible forms of co-operation are listed in Article 27:

(a) The court may appoint a person or body to act on its behalf;
(b) Any form of communication that is considered appropriate by the court;
(c) The administration and supervision of the debtor's affairs may be co-ordinated;
(d) The proceedings may be co-ordinated by court agreements;
(e) Concurrent proceedings regarding the same debtor may be co-ordinated.

6.6.1 Jurisdiction to commence a local proceeding

The Model Law imposes virtually no limitations on the jurisdiction of the courts in the enacting state to commence or continue local insolvency proceedings. Even after recognition of a foreign 'main' proceeding, jurisdiction remains with the courts of the enacting state to institute an insolvency proceeding if the debtor has assets in the enacting state.

The recognised foreign main proceedings constitutes proof that the debtor is insolvent to the purposes of commencing local proceedings (Article 31). Avoidance of the need for repeating proof of financial failure reduces the likelihood that a debtor may delay the commencement of the proceeding long enough to conceal or carry away assets.

6.6.2 Co-ordination of relief when local and foreign proceedings take place concurrently

The Model Law deals with co-ordination between a local proceeding and a foreign proceeding concerning the same debtor (Article 29). It also facilitates co-ordination between two or more foreign proceedings concerning the same debtor (Article 30). The objective of the provisions is to foster co-ordinated decisions that best achieve the objectives of both proceedings. This is usually the maximisation of the value of the debtor's assets or the most advantageous restructuring of the enterprise.

When the local insolvency proceeding is under way at the time that recognition of a foreign proceeding is requested, any relief granted for the benefit of the foreign proceeding must be consistent with the local proceeding. Furthermore, the existence of the local proceeding at the time the foreign main proceeding is recognised prevents the operation of Article 20. This would otherwise allow the stay of individual actions or enforcement proceedings against the debtor and a suspension of the debtor's right to transfer or encumber its assets.

When the local proceeding begins recognition or application for recognition of the foreign proceeding, the stay and suspension for the benefit of the foreign proceeding must be reviewed and modified. It must be terminated if it is inconsistent with the local proceeding.

When the court is faced with more than one foreign proceeding, relief should be tailored in such a way that will facilitate co-ordination of the foreign proceedings. If one of the foreign proceedings is a main proceeding, any relief must be consistent with that main proceeding: Article 30.

A creditor, by claiming in more than one proceeding, must not receive more than the proportion of payment that is obtained by other creditors of the same class: Article 32.

7 Saving a company: Chapter 11

FAST FORWARD

In the US, the main corporate rescue procedure is found in **Chapter 11** of the Bankruptcy Code. It is similar to the UK procedure, a key difference being that the directors retain control of the company.

7.1 What is Chapter 11?

Chapter 11 is the **corporate reconstruction** section of the **US Bankruptcy Code**. It sets out a procedure whereby the company is given a moratorium period to put together a plan of reorganisation for the company to be able to pay debts.

7.2 Who may apply?

The application under Chapter 11 may be made by the **company** (this is known as a **voluntary application**) or by at least three genuine unsecured **creditors** whose claims exceed a statutory amount (an **involuntary application**).

Involuntary applications tend to be rare, because there are severe **penalties** for creditors who make petitions wrongly.

7.3 Moratorium from debts

Once the court has approved an application and granted an order for proceedings under Chapter 11, a moratorium from debts commences, and the plan is being put together. This means that the company is given temporary relief from debts dating from before the application, and only has to pay certain debts after the application:

- Wages
- Expenses
- Taxes
- Administrative expenses

7.4 Plan of reorganisation

The **company** has **120 days** after the order has been granted to file a plan of reorganisation. This exclusive period may be extended by court order.

Other **interested parties** may gain a right to file a plan:

- If a trustee has been appointed (see below)
- If the company does not file a plan after 120 days
- If the plan is not accepted by the relevant parties after 180 days (see below)

These other **parties are**:

- The trustee
- A creditors' committee
- Equity security holders' committee
- A single creditor
- A single equity security holder
- An indenture trustee

The plan should set out:

- **Classes of claims and interests**
- Specify which classes are **not impaired** by the plan
- Specify which classes are **impaired** by the plan
- Provide the **same treatment for different debts** in each class (unless agreed otherwise)
- Provide adequate **means** for implementing the plan

The plan must be **approved** by the creditors in order to go ahead.

7.5 Appointment of committees

As soon as the order has been granted, the US Trustee shall appoint certain committees. The US Trustee in this case is comparable to the Official Receiver in the UK system.

The US Trustee **must** appoint a committee of **unsecured creditors**. This will normally comprise the persons holding the **seven largest claims** against the company.

The US Trustee **may** appoint additional committees, such as additional committees of creditors and equity security holders, on the same principle.

These committees may:

- **Consult** with the company concerning the administration of the case
- **Investigate** the acts, conduct, assets, liabilities, and financial condition of the company, the operation of the business, the desirability of continuing the business, and any other matter relevant to the case or to the formulation of a plan
- Participate in the formulation of a **plan**
- **Advise** those represented by committees of any plan formulated, and collect and file with the court acceptances or rejections of a plan
- Request the appointment of a **trustee or examiner**, and
- Perform such other services as are in the **interest** of those represented

7.6 Appointment of trustee in preference to company's management

In most cases of reorganisation, the **company's management are retained** to carry out the plan of reorganisation. However, in some limited circumstances, the court, on application on application from interested parties or the US Trustee, may appoint a trustee in preference to the company's own management. The circumstances are:

- Fraud, dishonesty, incompetence or gross mismanagement of the company's affairs
- If it is otherwise in the interests of creditors

Exam focus point

The fact that ordinarily the **company directors are retained** to carry out the plan of reorganisation is a significant difference between the UK and US systems. Another major difference between the UK and US system is the concept of **super-priority financing**.

7.7 Super-priority financing

In order to achieve the plan, it may be necessary to obtain **additional financing**. Chapter 11 provides for additional financing to be given extra priority over other debts.

8 Other national models

The following brief summaries are simply given for you to make basic comparisons between some of the insolvency models in the world.

8.1 France

In France, any insolvency procedure is highly **court-based**. Corporate rescue procedure is known as 'redressement judiciaire'.

8.2 Germany

The German insolvency code provides a **'single gateway'** to insolvency procedures, whereby the court will decide what the most appropriate solution for the company is.

8.3 Australia

The Australian model of corporate rescue is credited with being influential on the UK model of administration. **Administration in Australia** can be achieved voluntarily, without reference to the court. The procedure in Australia gives fewer powers to creditors than the UK system.

8.4 China

Corporate insolvency is a very new concept in China, where historically all business has been owned by the state. Insolvency law, therefore, is very much in a **development stage**.

Chapter Roundup

- **Liquidation** is the **dissolution** or '**winding up**' of a company.
- There are three different methods of **liquidation: compulsory**, **members' voluntary** and **creditors' voluntary**. Compulsory liquidation and creditors' voluntary liquidation are proceedings for insolvent companies, and members' voluntary liquidation is for solvent companies.
- A **liquidator** must be an authorised, qualified insolvency practitioner.
- Once **insolvency procedures** have commenced, share trading must cease, the company documents must state that the company is in liquidation and the directors' power to manage ceases.
- A **winding** up is **voluntary** where the decision to wind up is taken by the company members in general meeting, although if the company is insolvent, the creditors will be heavily involved in the proceedings.
- In order to be a members' winding up, the directors must make a **declaration of solvency**. It is a criminal offence to make a declaration of solvency without reasonable grounds.
- When there is no declaration of solvency there is a **creditors' voluntary winding** up.
- A creditor may apply to the court to wind up the company, primarily if the company is **unable to pay its debts**. There are statutory tests to prove that a company is unable to pay its debts
- A **dissatisfied member** may get the court to wind the company up on the **just and equitable ground**.
- The differences between compulsory and voluntary liquidation are associated with **timing**, the **role** of the **official receiver**, **stay of legal proceedings** and the **dismissal of employees**.
- An **administrator** is appointed primarily to try to rescue the company as a going concern. A company may go into administration to carry out an established plan to save the company.
- Some parties – **secured creditors** and **directors** and the **members** by resolution – can appoint an administrator without reference to the court.
- Various parties can apply for **administration** through the court.
- The **effects** of administration depend on whether it is effected by the **court** or by a **floating chargeholder**, to some degree.
- The administrator has **fiduciary duties** to the company as its agent, plus some legal duties.
- The administrator must either **propose a rescue plan**, or state that the **company cannot be rescued**.
- The administrator takes on the **powers** of the directors.
- Administration can last up to **12 months**.
- Administration has been found to have many advantages for the **company**, the **members** and the **creditors**.
- The Model Law allows insolvency proceedings begun in **one jurisdiction** to be recognised, facilitated and co-operated with in other jurisdictions. It has the aim of assisting in the rescue of financially troubled businesses, protecting the assets of insolvent debtors for the benefit of creditors, and maximising their overall value.
- In the US, the main corporate rescue procedure is found in **Chapter 11** of the Bankruptcy Code. It is similar to the UK procedure, a key difference being that the directors retain control of the company.

Quick Quiz

1 **Complete the following definition**.

Liquidation means that a company must be .... and its affairs wound up.

2 Name three common features of liquidations.

(1) ....

(2) ....

(3) ....

3 What are the two most important reasons for compulsory liquidation?

(1) ....

(2) ....

4 A members' voluntary winding up is where the members decide to dissolve a healthy company.

True ☐

False ☐

5 Rearrange the list in order of proceedings in a creditors' voluntary winding up.

(a) Creditors' meeting
(b) Liquidator appointed
(c) Directors' notice of meeting outlines situation
(d) Members' meeting
(e) Liquidation committee nominated

6 **Complete the following definition**, using the words given below.

An .... is an arrangement which puts an ....
.... in control of the business to attempt to save it.

• insolvency	• practitioner	• administration

7 Name two advantages of administration.

(1) ....

(2) ....

8 The key difference between the UK and US corporate rescue models is that in the UK, the directors retain their management positions.

True ☐

False ☐

Answers to Quick Quiz

1 Dissolved

2 (1) No further changes in membership permitted
(2) All documents must state prominently that company is in liquidation
(3) Directors' power to manager ceases

3 (1) Company is unable to pay its debts
(2) It is just and equitable to wind up the company

4 True. Members can decide to wind up a healthy company.

5 (c)
(d)
(a)
(b)/(e). Both these steps occur at the creditors' meeting

6 Administration, Insolvency, Practitioner

7 (1) It does not necessarily result in the dissolution of the company
(2) It prevents creditors applying for compulsory liquidation

Subsidiary advantages are

(3) All creditors an apply for an administration order
(4) The administrator may challenge past transactions of the company

8 False. The reverse is true.

Now try the question below from the Exam Question Bank

Number	Level	Marks	Time
Q19	Examination	10	18 mins

P A R T H

Governance and ethical issues relating to business

18

Corporate governance

Topic list	Syllabus reference
1 What is corporate governance?	H1(a)
2 Governance structures	H1(b), H1(c)
3 The Combined Code on Corporate Governance	H1(b)
4 The German Corporate Governance Code	H1(b)
5 Legal regulation of corporate governance	H1(c)

Introduction

Corporate governance is about the direction and control of a company. In this Chapter we shall start to look at the structures put in place to ensure that companies are managed well and in the best interests of the owners (the shareholders).

The law sets out basic principles. The **directors manage** the company, as we saw in Chapter 15. The **owners** are entitled to retain **ultimate control** over company strategy by exercising powers in **general meetings**, as we saw in Chapter 16.

In recent years, much attention has been focused on the issue of **corporate governance**. This is because in recent times **company failure** due to poor management or even fraud by management has had a significant impact on large numbers of people. The response to the need for better governance has been both extra-legal and statutory. We shall look in Section 3 at the UK's Combined Code on Corporate Governance (as 'extra-legal' approach) and at the US Sarbanes-Oxley Act (a statutory approach).

Study guide

		Intellectual level
H	**Governance and ethical issues relating to business**	
1	**Corporate governance**	
(a)	Explain the idea of corporate governance	2
(b)	Recognise the extra-legal codes of corporate governance	2
(c)	Identify and explain the legal regulation of corporate governance	2

Exam guide

There are many issues that have an impact on corporate governance, and it will feature in some form on every exam paper, either explicitly (such as in a question on the Combined Code) or implicitly (such as in a question on directors' duties).

PER alert

PER 2 requires you to contribute to the effective governance of an organisation. The material in this chapter will be of use to identify common governance issues and how to resolve them.

1 What is corporate governance?

FAST FORWARD

Corporate governance is simply a term used for **the way that companies** (corporate) **are run and operated** (governed).

Key term

Corporate governance is the system by which companies are directed and controlled. *Cadbury Report*

According to the OECD:

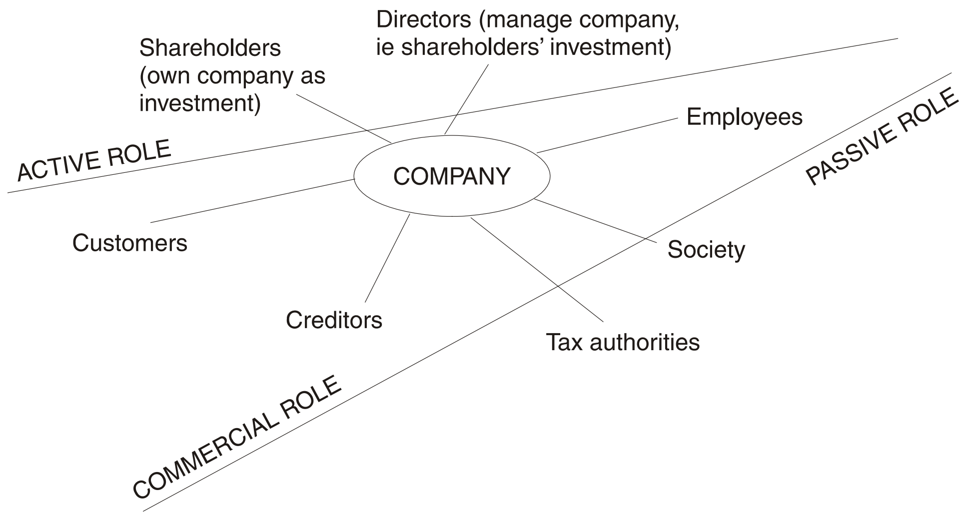
> 'Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.' *OECD*

1.1 A company's stakeholders

FAST FORWARD

There are many different **stakeholders** in most companies.

As is made clear in the quotation from the OECD above, a company has **various interested parties**, known as **stakeholders**. Examples include:



Each of the stakeholders has a **different role**, some of which are more passive than others. For example, **society** is a stakeholder in a company, but it is generally a **passive** participant. The tax authorities passively receive income from the company's profits. Customers, employees and creditors are more active, playing the 'commercial' role that keeps the company's operations going.

1.2 Shareholders and directors

FAST FORWARD

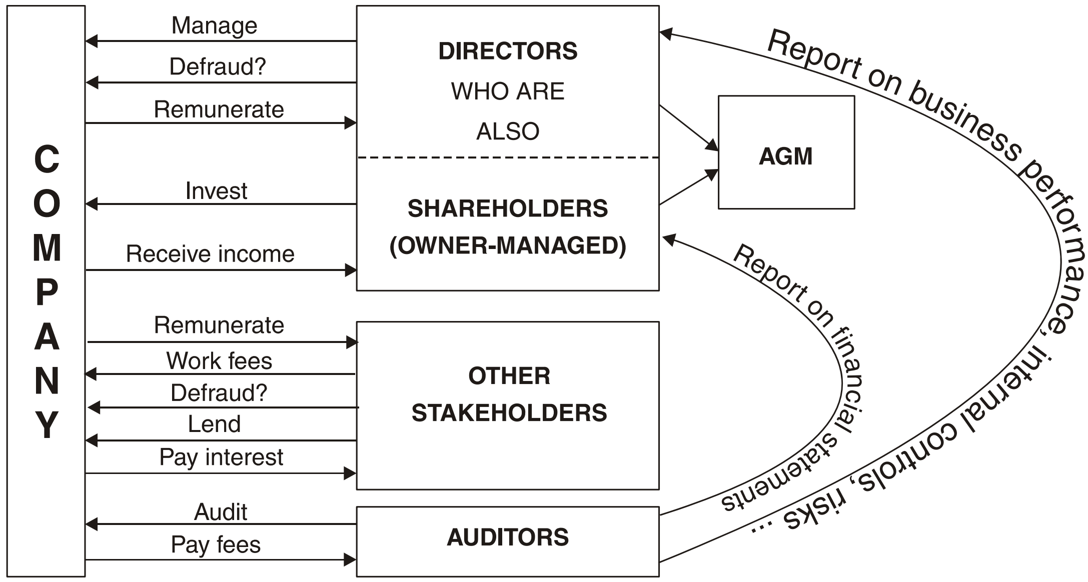
The stakeholders most closely involved in corporate governance are the **directors** (the managers of the company) and the **shareholders** (who have some ultimate controls in general meeting).

The key active stakeholders are **shareholders**, who **own the company**, and **directors**, who **manage the company**, and therefore, they manage the shareholders' investment.

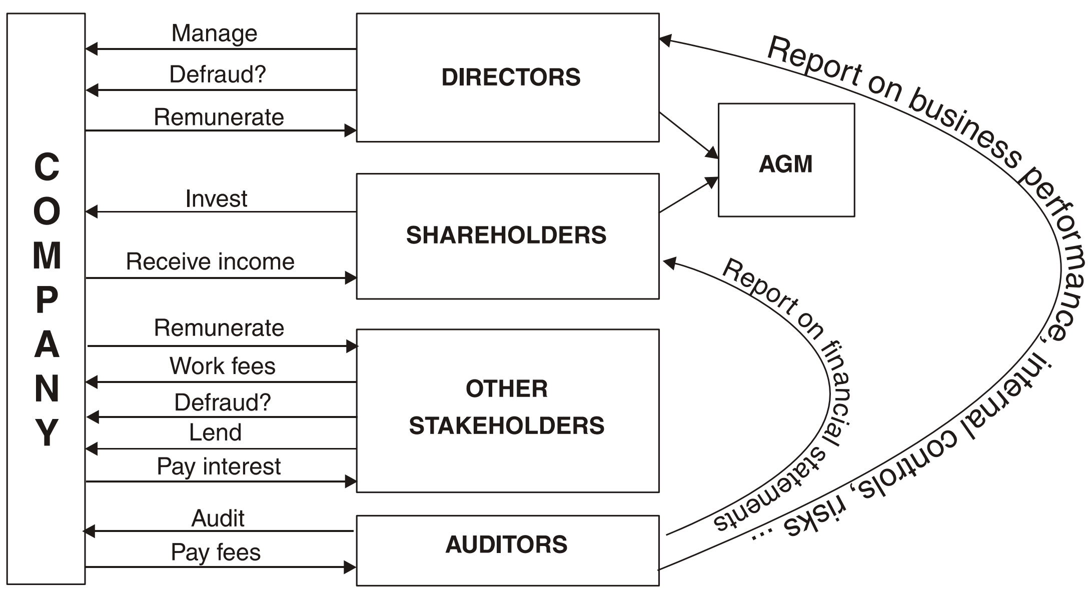
Corporate governance is therefore all about **shareholders** (the owners) and **directors** (the management), as between them they direct and control the company. A UK government report on corporate governance in 1992, the **Cadbury report**, identified the role of directors:

'The directors are responsible for the corporate governance of the company.'

Sometimes, particularly in smaller businesses, companies are **owned and managed by the same people**. This is the situation where people form a company to carry out their own business, buy the shares and appoint themselves as directors. Such companies are known as 'owner-managed businesses'. The first diagram on the next page illustrates such a company.



In other, often **bigger**, companies, the directors and shareholders are different sets of people. Often in larger companies quoted on stock exchanges, **shareholders** purchase shares as an investment and may have very little personal contact with the company. **Directors** are employed for their management expertise and have no other connection with the company. The diagram below illustrates such a company.



1.2.1 Knowledge gap

These two diagrams illustrate two positions between which there is a wide spectrum. They also illustrate a key difference between the two companies, which is a '**knowledge gap**'.

In the **owner-managed company**, as the directors and shareholders are the same people, they have **access to the same information** and are **in a position to direct company policy**. In the other company, the shareholders do not have access to day-to-day company management information.

This 'gap' in the shareholders' knowledge may cause difficulty for **investors**, who **will want to be assured that their investment is being managed correctly and in accordance with their wishes, as owners**. Company law and practice have adopted various measures to attempt to bridge the gap.

- Financial statements
- Annual general meetings
- Corporate governance codes

1.3 Financial statements

FAST FORWARD

Directors must prepare financial statements for **shareholders annually**, and these are independently audited to provide an objective check on the directors.

As we discussed in Chapter 10, the directors are required by law to **report to members** on the **financial position** of the company on an annual basis.

Company law requires that an independent professional **audits** these financial statements to ensure that they **give a true and fair view**. The Cadbury report on corporate governance (mentioned earlier) referred to the **audit** as a **cornerstone of good corporate governance**, as it gives an **objective check** on the stewardship of the directors.

1.4 Annual general meeting (AGM)

FAST FORWARD

At the AGM the shareholders can exercise their **ultimate control**.

The AGM is the **key shareholder meeting**. It gives **shareholders** an opportunity to **conduct dialogue with directors and to be heard by them**. There is also some **routine business** carried out at an AGM. For example, it is the meeting at which the financial statements are presented to the shareholders and the meeting at which directors and auditors are re-elected.

Although directors make day-to-day management decisions for the company, **shareholders retain control of the major company policy at company meetings**. Remember that, as we have observed in previous chapters, **certain key decisions and capabilities**, such as amending the object of the company or authorising additional share capital, are **retained by shareholders in general meetings**.

Despite the legal protection of the AGM for shareholders, they are often been poorly attended by shareholders. Also where shareholders invest in the largest of companies, there is often **apathy amongst shareholders** about decisions taken by management. This **reduces the effectiveness** of the statutory protection to shareholders given by the AGM and **can expose the company to poor management, and even fraud**.

1.5 Voluntary codes of corporate governance

FAST FORWARD

Following high-profile **corporate failures**, corporate governance codes set out best practice.

Although these interrelated issues have always been of concern in the way companies function, the recent increase in the attention placed on matters of corporate governance has been a result of the perceived **weaknesses** in company regulation. These have become apparent in some of the recent **scandals** involving large companies such as Enron and Worldcom in the US, and Marconi and Parmalat in Europe.

In order to ensure an **effective corporate governance framework it** has been deemed necessary to set out defined rules and regulations, including voluntary codes. The UK has the **Combined Code on Corporate Governance**, which is the result of the review of the role and effectiveness of non-executive directors conducted by Derek Higgs and a review of audit committees conducted by Sir Robert Smith. The revised combined code has applied to listed companies since June 2006. Companies have either to confirm that they **comply** with the Code's provisions or, where they do not, to **provide an explanation** of their non-compliance. Whilst listed companies are expected to comply with the Code's provisions most of the time, it is recognised that departure from its provisions may be justified in particular circumstances. Every company must review each provision carefully and give a considered explanation if it departs form the Code provisions.

As well as the UK's Combined Code, we shall also look briefly at the German corporate governance code.

1.5.1 Voluntary or prescriptive?

A feature of the two codes outlined above is that they are both voluntary 'extra-legal' codes. The company is required to report if it has not complied with the Code, but it is not required to comply with the Code (unless it is a listed company and therefore required to do so under the UKLA rules).

An alternative approach would be for governments to make such corporate governance requirements mandatory for companies. This approach is often shunned, arguments in favour of keeping codes voluntary include:

(a) The fact that all companies are different and the make up of their stakeholders is different means that statutory standards might be **inflexible**. The **additional costs** and regulatory burdens **might not be justified** in all cases.

(b) In such cases, the result might be **detrimental to shareholders** (in terms of cost) who are key stakeholders the regulation is seeking to protect.

(c) Statutory **monitoring** of compliance would be required, which again could add to the burden for the company.

(d) Some of the requirements of the codes are **subjective** (for example, in relation to non-executive directors) and it would be difficult to proscribe regulations in respect of them.

While codes are not mandatory, or legally required, they are **heavily encouraged**, particularly for listed companies, and **companies not complying with such requirements may find that they suffer in investment markets as a result**.

Question — Good corporate governance

Why is good corporate governance important?

Answer

Shareholders and managers are usually separate in a company and it is important that the management of a company deals fairly with the investment made by the owners.

2 Governance structures

FAST FORWARD

Whether their status is down to voluntary or statutory rules, there are certain aspects of governance, or **'governance structures'** which are generally acceptable.

2.1 The split between executive and non-executive directors

One of the best forms of internal control is the segregation of duties, separating the roles of directors into those who have **executive** powers (the power to **manage** the company) and those who have **non-executive** powers (the power to **direct** and **control** the company).

In Chapter 15 we looked briefly at the difference between executive and non-executive directors. We shall come back to them shortly when we cover the Combined Code.

2.2 Unitary board of directors

FAST FORWARD

The UK, US and many other countries have a **unitary board** system, where there is one board to run a company.

The UK and many other countries, including the US, follow a **single**, sometimes called a **unitary**, **board** structure. This is where the company is **managed by a single board of directors**.

This board may be formed of executive directors only, or a mixture of executive and non-executive directors. The Combined Code, which we shall look at shortly, gives significant guidance about the **composition of unitary boards**.

We shall consider the **advantages and disadvantages** of a unitary board structure later, as it will be easier to see the advantages and disadvantages in comparison to the other major type of board structure used internationally, the supervisory board structure.

2.2.1 Composition of the unitary board

There are **very few legal requirements** relating to the composition of a unitary board. As we have discussed above, there are requirements concerning the **number of directors** a company has and there are requirements concerning **quorum**. There are also requirements about **who is allowed to be a director** as we saw in Chapter 15. The law is otherwise silent on the composition of the board.

2.3 Supervisory board structure

FAST FORWARD

In Germany and some other countries, a supervisory board system is used. This means that there is a **management board to run the company** plus a **supervisory board to oversee** the management board.

Some countries, notably **Germany** and Holland, use a different board structure to the UK and others. The type of board structure used in Germany, which we shall use as exemplar, is known as the **supervisory board structure**, sometimes called the **two-tier or dual system**.

The supervisory board system involves the use of two boards, **management** (known in Germany as **Vorstand**) and **supervisory** (known in Germany as **Aufsichtsrat**). The management board is loosely comparable to the British unitary board, and it has general responsibility to **manage** the company. The Aufsichtsrat is an **independent, separate board**.

It is a legal requirement that **all public limited companies** in Germany (AGs) **must have an Aufsichtsrat**. For private limited companies (GmbHs), the requirement is based on size. It is only a requirement for **GmbHs with more than 500 employees** to **have an Aufsichtsrat**. However, **smaller GmbHs may choose** to have such a supervisory board, **at the discretion of shareholders**.

2.3.1 Composition of the supervisory board

The supervisory board consists of **members elected by the shareholders and by employees of the company**. Usually, a third of the board is elected by the employees and the remainder by the shareholders. If the company has more than 2,000 employees, half the members of the Aufsichtsrat must be representatives of the employees of the company.

2.3.2 Role of the supervisory board

The **supervisory board** has an advisory role in relation to the business. It has the following key powers:

- Appoints members of the Vorstand
- May request information from members of the Vorstand
- Must be formally reported to about matters of policy
- Must be formally reported to about profit and loss
- Must be formally reported to about the state of the company's affairs
- Must be formally reported to in exceptional circumstances
- Approves the income statement, balance sheet and dividends
- Inspects the books and accounts
- May set up committees and delegate jobs to them
- May initiate independent investigations
- May convene shareholder meetings
- May remove Vorstand members (as a last resort and on legitimate grounds)

However, this power is limited in that it does not have power to manage the company, only to **supervise the managers**. It is not entitled to make **policy decisions** and cannot represent the company in **legal action**.

2.4 Unitary board and supervisory board compared

FAST FORWARD

In practice, the **principles of independence and verification behind both the unitary and the dual systems are increasingly growing closer**. **Both systems face similar problems** in terms of finding **suitably qualified people** to undertake supervisory roles and to be an **independent** voice in a company.

2.4.1 Advantages of the unitary board structure

The fact that all participants in the management of the company are given responsibility for management of the company suggests a **more involved approach** by those directors who are non-executive directors and therefore act in an independent and 'supervisory' capacity.

If all the directors attend the same meetings, the **independent directors** are **less likely to be** effectively **excluded from decision-making and given restricted access to information**. The **presence of non-executive directors** to question the actions and decisions of executive directors as they are taking place **should lead to better decisions being made**.

2.4.2 Criticisms of the unitary board structure

Asking an 'external' or 'independent' director to be **both manager and supervisor** may be **too awkward and demanding a task**.

Criticism has also been made of the requirement to have as many independent non-executive directors as executive directors on the board. Who are these non-executive directors? Where are people with such expertise and time-availability to be found?

The criticism is intensified when the **independence requirement** is considered. It raises questions such as: How can people who fulfil the independence requirement be expected to have sufficient knowledge about the company to properly fulfil their management capacity?

The supervisory board system takes account of the needs of stakeholders other than shareholders, specifically **employees**, who are clearly important stakeholders in practice. The unitary board system makes no specific provision for employees to be represented on the management board, other than by the people who employ them.

The unitary board **emphasises the divide between the shareholders and the directors** as there is no crossover between them. It **puts pressure on the annual general meeting** as the only place where shareholder grievance or concern can be heard.

2.4.3 Advantages of the supervisory board structure

The formal supervisory role given to the members of the Aufsichtsrat has the **capacity** to be an **effective guard** against management inefficiency or worse. Indeed its very existence may be a **deterrent** to fraud or irregularity in a similar way to the independent audit.

The system actively **encourages transparency within the company**, between the boards and, through the supervisory board, to the employees and the shareholders. This is in sharp contrast to the closed doors policy of UK boards.

It also **actively involves the shareholders and employees** in the supervision and appointment of directors.

2.4.4 Criticisms of the supervisory board structure

The main criticism of the system centres around the fact that in practice, the supervisory board may not be as effective as it seems in theory:

- The **management board may restrict the information passed** on to the supervisory board
- In practice, the boards may only liaise infrequently

The supervisory board may not be as **independent** as would be wished, depending on how rigorous the appointment procedures are. In addition, members of the supervisory board can be shareholder representatives, and this could detract from the legal requirement that shareholders should not instruct directors how to manage.

The German **stock market** has also suffered from the fact that foreign companies are not familiar with the management systems their companies operate, although this is not a qualitative criticism.

2.5 Board committees

Whether a unitary or a supervisory board system is used, the effective operation of the board is often facilitated by the creation of **board committees**. Authority of the board as a whole is delegated to these committees with respect to certain defined areas, such as audit, directors' remuneration and nominations/ appointments to the board.

We shall come back to the work and composition of board committees when we look at the UK Combined Code.

3 The Combined Code on Corporate Governance

FAST FORWARD

Guidance on the composition of a unitary board in the UK is given in the **Combined Code on Corporate Governance**. This sets out a series of principles about how boards should be composed: effective board collectively responsible for the success of the company; balance of non-executive and executive directors; division of responsibility between the chief executive and the chairman.

As we are using the **UK regime** as exemplar of company law, we shall look here at the requirements of its **Combined Code on Corporate Governance** in relation to the composition of boards. The Code has recently been revised and, in the form below, applies to companies listed on the **London Stock Exchange**. It is set out in terms of main and supporting principles, and code provisions.

Exam focus point

Do not attempt to rote learn the contents of the Combined Code. Exam questions are likely to focus on the principles of corporate governance rather than the detail.

3.1 Effective board

Principle

Every company should be headed by an **effective board**, which is **collectively responsible** for the success of the company.

A key point to be made about the single board is that on a unitary board, **every director has responsibility for the success of the company**. **Every director has an active role in managing the company**, not just in supervising the company. Contrast this to the supervisory board system.

3.1.1 Principles supporting an effective board

The board's role is to provide **entrepreneurial leadership** of the company within a framework of prudent and effective controls.

The board should:

(a) Set the company's **strategic aims**,

(b) Ensure that the **necessary financial and human resources** are in place for the company to meet its objectives, and

(c) **Review management performance**.

The board should set the company's **values and standards** and ensure that its **obligations** to its shareholders and others are understood and met.

All directors must take decisions **objectively in the interests of the company**.

Non-executive directors should:

(a) Constructively challenge and help develop proposals on strategy

(b) Scrutinise the performance of management in meeting agreed goals and objectives

(c) Monitor the reporting of performance

(d) Satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible

(e) Be responsible for determining appropriate levels of remuneration of executive directors

(f) Have prime roles in appointing, and where necessary removing, executive directors, and in succession planning.

3.1.2 Provisions supporting an effective board

1 The board should meet regularly with a formal schedule of matters specifically reserved for its decision.

2 The annual report should include a statement of how the board operates, including a high level statement of which types of decision are taken by the board and which are delegated to management.

3 The annual report should identify the chairman, the deputy chairman (where there is one), the chief executive, the senior independent (non-executive) director and the chairmen and members of the nomination, audit and remuneration committees. It should also set out the number of meetings of the board and those committees and individual attendance by directors.

4 The chairman should hold meetings with the non-executive directors without the executives present. Led by the senior independent director, the non-executive directors should meet without the chairman present at least annual to appraise the chairman's performance and on such other occasions as are deemed appropriate.

5 Where directors have concerns which cannot be resolved about the running of the company or a proposed action, they should ensure that their concerns are recorded in the board minutes.

6 On resignation, a non-executive director should provide a written statement to the chairman, for circulation to the board, if they have any such concerns.

7 The company should arrange appropriate insurance cover in respect of legal action against its directors.

3.2 Chairman and chief executive

Principle

There should be a clear division of responsibilities at the head of the company between the running of the board and the executive with responsibility for the running of the company's business. No one individual should have unfettered powers of decision.

3.2.1 Principles supporting division of responsibilities

The **chairman** is responsible for:

(a) Leadership of the board, ensuring its effectiveness on all aspects of its role and setting its agenda
(b) Ensuring that the directors receive accurate, timely and clear information
(c) Ensuring effective communication with shareholders
(d) Facilitating the effective contribution of non-executive directors in particular
(e) Ensuring constructive relations between executive and non-executive directors

3.2.2 Provisions supporting division of responsibilities

1 The roles of chairman and chief executive should be exercised by different individuals. The division of responsibilities between the chairman and chief executive should be clearly established, set out in writing and agreed by the board.

2 The chairman should on appointment be independent.

3 A chief executive should not go on to be chairman of the same company. If exceptionally a board decides that a chief executive should become chairman, the board should consult major shareholders in advance. It should set out its reasons to shareholders at the time of the appointment and in the next annual report.

3.3 Balance and independence of the board

Principle

The board should include a balance of executive and non-executive directors (and in particular independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision making.

3.3.1 Principles supporting a well-balanced board

The board should be **big enough** that the balance of skills and experience is appropriate for the requirements of the business, and that changes to the board's composition can be managed without undue disruption. The board should **not be so large** as to be unwieldy.

There should be a **strong presence** on the board of both executive and non-executive directors, so that power and information are not concentrated in one or two individuals.

Membership of board committees needs to be refreshed and undue reliance should not be placed on particular individuals, such as the committee chairman.

Only the committee chairman and members are entitled to be present at a meting of the nomination, audit or remuneration committees, though others may attend at the invitation of the committee.

3.3.2 Provisions supporting a well-balanced board

1 The board should identify in the annual report each non-executive director (excluding the chairman of the board) it considers to be independent. The board should determine whether the director is **independent in character and judgement** and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant.

2 A director **may** be determined as being **not independent** if he/she:

- Has been an employee of the company or group within the last five years;
- Has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;

- Has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- Has close family ties with any of the company's advisers, directors or senior employees;
- Represents a significant shareholder; or
- Has served on the board for more than nine years from the date of their first election.

3 At least 50% of the board excluding the chairman, should comprise of **independent non-executive directors**.

4 The board should appoint one of the independent non-executive directors to be the **senior independent director**. The senior independent director should be available to shareholders if they have unresolved concerns, or where contact with executive directors is inappropriate.

3.4 Appointments to the board

Principle

There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board.

3.4.1 Principles supporting the procedure for board appointment

Appointments to the board should be made **on merit** and against **objective criteria.** Especially for chairmanship, care should be taken to ensure that appointees have **enough time** available to devote to the job.

The board should satisfy itself that plans are in place for orderly **succession for appointments** to the board and to senior management. The plans should **maintain an appropriate balance of skills and experience** within the company and on the board.

3.4.2 Provisions supporting board appointment procedure: the nomination committee

1 There should be a **nomination committee** which should lead the process for board appointments and make recommendations to the board.

2 Over **50%** of members of the nomination committee should be independent non-executive directors.

3 The board chairman or an independent non-executive director should **chair the committee**. However, the board chairman should not chair the nomination committee when it is dealing with the appointment of a successor to the chairmanship.

4 The nomination committee should make available its **terms of reference**, explaining its role and the authority delegated to it by the board.

5 The nomination committee should evaluate the **balance of skills, knowledge and experience on the board**. Then in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment.

6 For the appointment of the **board chairman**. The nomination committee should prepare a job specification, including an assessment of the time commitment expected, recognising the need for availability in the event of crises.

7 A chairman's other significant commitments should be disclosed to the board before appointment and included in the annual report. Changes to such commitments should be reported to the board as they arise, and include in the next annual report.

8 No individual should be appointed to a second chairmanship of a FTSE 100 company.

9 The **terms and conditions of appointment** of non-executive directors should be made available for inspection at the registered office.

10 The letter of appointment for non-executive directors should set out the expected time commitment. Non-executive directors should undertake that they will have **sufficient time** to meet what is expected of them.

11 Non-executive directors should disclose their other significant commitments to the board before appointment and the board should be informed of subsequent changes.

12 A full time executive should not be allowed to take on more than one non-executive directorship in a FTSE 100 company nor the chairmanship of such a company.

13 A separate section of the **annual report** should describe the work of the nomination committee, including the process it has used in relation to board appointments.

14 An explanation should be given if neither an external search consultancy nor open advertising has been used in the appointment of a chairman or a non-executive director.

3.5 Information for and professional development of the board

Principle

> The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.

3.5.1 Principles supporting the well-informed, professional board

The board chairman is responsible for ensuring that the **directors receive accurate, timely and clear information**. Management is obliged to provide such information but directors should seek clarification or amplification where necessary.

The board chairman should ensure that the **directors continually update their skills** and the knowledge and familiarity with the company required to fulfil their role both on the board and on board committees. The company should provide the necessary resources for developing and updating its directors' knowledge and capabilities.

Under the direction of the chairman, the **company secretary's** responsibilities include ensuring good information flows within the board and its committees and between senior management and non-executive directors, they should facilitate induction and assist with professional development as required. The company secretary should also be responsible for advising the board through the chairman on all **governance matters**.

3.5.2 Provisions supporting the well-informed, professional board

1 The chairman should ensure that the new directors receive a **full, formal and tailored induction on joining the board**. As part of this, the company should offer to **major shareholders** the opportunity to **meet a new non-executive director**.

2 The board should ensure that directors have access to **independent professional advice** at the company's expense where they judge it necessary to discharge their responsibilities as directors.

3 **Committees** should be provided with sufficient resources to undertake their duties.

4 All directors should have access to the advice and services of the **company secretary**, who is responsible to the board for ensuring that board procedures are complied with.

5 Both the **appointment and removal of the company secretary** should be a matter for the board as a whole.

3.6 Evaluation of the board's performance

Principle

> The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.

3.6.1 Principles for evaluating the board's performance

Each director should be **individually evaluated** to ensure they continue to contribute effectively and to demonstrate commitment to the role. The chairman should **act on the results of the performance evaluation** by recognising the strengths and addressing the weaknesses of the board. Where appropriate, the chairman should propose that new members be appointed to the board, or should seek the resignation of directors.

3.6.2 Provisions for evaluating board performance

1. The board should state in the **annual report** how performance evaluation of the board, its committees and its individual directors has been conducted.
2. The **non-executive directors**, led by the senior independent director, should be responsible for performance evaluation of the chairman, taking into account the views of executive directors.

3.7 Re-election of directors

Principle

All directors should be submitted for re-election at **regular intervals**, subject to continued satisfactory performance. The board should ensure planned and progressive refreshing of the board.

3.7.1 Provisions for re-election of directors

1. All directors should be subject to election by shareholders at the **first AGM** after their appointment.
2. All directors should be subject to re-election thereafter at intervals of **no more than three years**.
3. The names of directors submitted for election should be accompanied by **biographical details** and any other relevant information to enable shareholders to take an informed decision on their election.
4. **Non-executive directors** should be appointed for specified terms subject to re-election and to Companies Acts provisions relating to the removal of a director.
5. Accompanying a resolution to elect a non-executive director should be papers from the board setting out why they believe an individual should be elected.
6. The chairman should confirm to shareholders that, following formal performance evaluation, the individual's performance continues to be effective and to demonstrate commitment to the role.
7. Any term beyond six years for a non-executive director should be subject to particularly rigorous review, and should take into account the need for progressive refreshing of the board.
8. Non-executive directors may only serve longer than nine years if they are subject to annual re-election. Serving more than nine years could be relevant to the determination of a non-executive director's independence.

3.8 Level and make-up of directors' remuneration

Principle

Levels of remuneration should be sufficient to **attract, retain and motivate directors** of the quality required to run the company successfully. A company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to **link rewards to corporate and individual performance**.

3.8.1 Principles supporting the right level and make-up: the remuneration committee

In relation to the level and make-up of directors' remuneration, the **remuneration committee** should judge where to position their company relative to other companies. They must **avoid an upward ratchet of remuneration levels with no corresponding improvement in performance**. They should also be sensitive to pay and employment conditions elsewhere in the entity especially when determining annual salary increases.

3.8.2 Provisions supporting the right level and make-up of remuneration

Remuneration policy:

1 The **performance-related elements** of remuneration should:

- (a) Form a significant proportion of the total remuneration package of executive directors, and
- (b) Be designed to align their interests with those of shareholders, and
- (c) Give these directors keen incentives to perform at the highest levels.

2 **Executive share options** should not usually be offered at a discount.

3 Levels of remuneration for **non-executive directors** should:

- (a) Reflect the time commitment and responsibilities of the role
- (b) Not include share options (as these can undermine independence). This is unless shareholder approval is sought in advance and any shares acquired by exercise of the options are held until at least one year after the non-executive director leaves the board.

4 Where an executive director is released to serve as a non-executive director elsewhere, the **remuneration report** should include a statement of whether or not the director will retain such earnings and, if so, what the remuneration is.

Service contracts and compensation:

1 The remuneration committee should carefully consider **compensation commitments** for early termination of service contracts. The aim should be to avoid rewarding poor performance. They should take a robust line on reducing compensation to reflect departing directors' obligations to mitigate loss.

2 Notice or contract periods should be set at **one year or less**. If it is necessary to offer longer notice or contract periods to new directors recruited from outside, such periods should reduce to one year or less after the initial period.

3.9 Transparency of remuneration

Principle

There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

3.9.1 Principles supporting transparency

The **remuneration committee** should:

(a) Consult the chairman and/or chief executive about their proposals relating to the remuneration of other executive directors

(b) Be responsible for appointing any consultants in respect of executive director remuneration

Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to recognise and avoid **conflicts of interest**.

The board chairman should ensure that the company maintains contact as required with its **principal shareholders about remuneration** in the same way as for other matters.

3.9.2 Provisions supporting transparency

1 The board should **establish a remuneration committee** of at least three independent non-executive directors.

2 The board chairman may be a member of, but **not chair**, the committee if he or she was considered independent on appointment as chairman.

3 The remuneration committee should make available its **terms of reference**, explaining its role and the authority delegated to it by the board.

4 Where **remuneration consultants** are appointed, a statement should be made available of whether they have any other connection with the company.

5 The remuneration committee should have delegated responsibility for **setting remuneration for all executive directors and the chairman**.

6 The committee should also recommend and monitor the level and structure of remuneration for senior management. The definition of 'senior management' for this purpose should be determined by the board but should normally include the first layer of management below board level.

7 The board itself or, where required by the Articles, the shareholders should **determine the remuneration of the non-executive directors** within the limits set in the Articles. Where permitted by the Articles, the board may however delegate this responsibility to a committee, which might include the chief executive.

8 **Shareholders** should be invited specifically to approve all new **long-term incentive schemes** and significant changes to existing schemes.

3.10 Financial reporting

Principle

> The board should present a balanced and understandable assessment of the company's position and prospects.

3.10.1 Principle supporting balanced and understandable financial reporting

The board's responsibility to present a balanced and understandable assessment extends to:

(a) **Interim reports**
(b) **Other price-sensitive public reports**
(c) Reports to **regulators**
(d) The statutory financial statements

3.10.2 Provisions supporting good financial reporting

1 The directors should explain in the annual report their **responsibility for preparing the accounts**

2 The **auditors** should explain their reporting responsibilities in the annual report

3 The directors should report that the business is a **going concern**, with supporting assumptions or qualifications as necessary

3.11 Internal control

Principle

> The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.

3.11.1 Provision supporting internal control

The board should annually, conduct a **review of the effectiveness of the company's system of internal controls** and should report to shareholders that they have done so. The review should cover all material controls, including **financial controls** and operational and compliance and risk management systems.

3.12 Auditing

Principle

> The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's' auditors.

3.12.1 Provisions supporting audit

1. The board should establish an **audit committee** of at least **three independent non-executive directors.**
2. At least one member of the audit committee should have **recent and relevant financial experience**.
3. Role and responsibilities of the audit committee:
   - To monitor the **integrity of the financial statements** of the company, and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
   - To review the company's **internal financial controls** and to review the company's internal control and risk management systems;
   - To monitor and review the **effectiveness of the company's internal audit function**;
   - To make recommendations to the board and thereby to shareholders for their approval in general meeting regarding the **appointment, re-appointment and removal of the external auditor**. This includes the approval of the **remuneration and terms of engagement** of the external auditor;
   - To review and monitor the external auditor's **independence and objectivity** and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
   - To develop and implement policy on engaging external auditors to supply **non-audit services**, taking into account relevant ethical guidance; and to report to the board on this.
4. A separate section of the **annual report** should describe the work of the audit committee in discharging its responsibilities.
5. **Whistle-blowing**: the audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. Arrangements should be in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.
6. The audit committee should monitor and review the effectiveness of the **internal audit** activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board.
7. The audit committee should have primary responsibility for making a recommendation on the appointment, re-appointment and removal of the **external auditors**. If the board does not accept the audit committee's recommendation, it should include in the annual report, a statement from the audit committee explaining the recommendation and set out reasons why the board has taken a different position.
8. The annual report should explain to shareholders how, if the auditor provides **non-audit services**, auditor objectivity and independence is safeguarded.

3.13 Dialogue with shareholders

Principle

> There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place.

3.13.1 Principles supporting relations with shareholders

Nothing should override the general requirements of law to treat shareholders equally in access to information.

Most shareholder contact is with the chief executive and finance director. However, the board chairman (and the senior independent director) should maintain sufficient contact with major shareholders to **understand their issues and concerns**.

The board should keep in touch with shareholder opinion in whatever ways are most practical and efficient.

3.13.2 Provisions supporting relations with shareholders

1. The board chairman should ensure that the **views of shareholders** are communicated to the board as a whole.
2. The chairman should **discuss governance and strategy** with major shareholders.
3. **Non-executive directors** should be offered the opportunity to attend meetings with major shareholders and should expect to attend them if requested by major shareholders.
4. The **senior independent director** should attend sufficient meetings with a range of major shareholders to listen to their views in order to help develop a balanced understanding of the issues and concerns of major shareholders.
5. The board should state in the **annual report** the steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about their company. For example, through face-to-face contact, analysts' or brokers' briefing and surveys of shareholder opinion.

3.14 Using the AGM

Principle

> The board should use the AGM to communicate with investors and to encourage their participation.

3.14.1 Provisions supporting the use of the AGM

1. At any general meeting, the company should propose a **separate resolution on each substantially separate issue**. For example, particular, proposing a resolution at the AGM relating to the **report and accounts**.
2. For each resolution, **proxy appointment forms** should provide shareholders with the option to direct their proxy to vote either for or against the resolution or to withhold their vote.
3. The proxy form and any announcement of the results of a vote should make it clear that a '**vote withheld**' will not be counted in the calculation of the proportion of the votes for and against the resolution.
4. The company should ensure that all **valid proxy appointments** received for general meetings are properly recorded and counted.

5 For each resolution, after a vote has been taken, except where taken on a poll, the company should ensure that the following **information is given at the meeting and on the company website**:

- The number of shares in respect to which proxy appointments have been validly made;
- The number of votes for the resolution;
- The number of votes against the resolution; and
- The number of shares in respect of which the vote was directed to be withheld.

6 The chairman should arrange for the **chairmen of the audit, remuneration and nomination committees** to be available to answer questions at the AGM, and for **all directors to attend**.

7 The company should arrange for the Notice of the AGM and related papers to be sent to shareholders at least **20 working days** before the meeting.

3.15 Dialogue with companies by institutional shareholders

Principle

Institutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives.

When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional shareholders should give due weight to all relevant factors drawn to their attention.

3.15.1 Principle supporting dialogue by institutional shareholders

Institutional shareholders should consider carefully explanations given for **departure from this Code** and make reasoned judgements in each case. If they do not accept the company's position they should give an explanation to the company, in writing where appropriate, and be prepared to enter a dialogue. They should avoid a box-ticking approach to assessing a company's corporate governance. They should bear in mind in particular the size and complexity of the company and the nature of the risks and challenges it faces.

3.16 Voting by institutional shareholders

Principle

Institutional shareholders have a responsibility to make considered use of their votes.

3.16.1 Principles supporting voting by institutional shareholders

Institutional shareholders should take steps to ensure their voting intentions are being translated into practice. On request, they should make information available to their clients on the proportion of resolutions on which votes were cast and non-discretionary proxies lodged.

Major shareholders should attend AGMs where appropriate and practicable. Companies should facilitate this.

4 The German Corporate Governance Code

FAST FORWARD

The **German Corporate Governance Code** gives guidance about the composition and role of management and supervisory boards.

The Code was adopted by the German government in February 2002. It is **primarily aimed** at **listed companies**, but it is recommended that all companies respect the Code. The code is **not mandatory**, and is termed in the **form of recommendations**. However, companies that deviate from its requirements are asked to **disclose** the fact that they have deviated annually.

We shall concentrate on the sections of the codes relating to the management and supervisory boards.

4.1 Management board

The Code sets out the tasks and responsibilities of the board, which are:

- Managing the enterprise (including acting in its best interests)
- Developing strategy
- Abiding by provisions of law
- Ensuring appropriate risk management

The Management Board shall be comprised of **several persons** and have a **Chairman** or Spokesman. Terms of reference shall regulate the areas of responsibility and the co-operation in the Management Board.

The Code also sets out how directors are to be compensated (**remunerated**). The level of pay is to be set by the **supervisory board**. Lastly it looks at the issue of **conflicts of interest** and the duties that the members of the management board owe the company.

4.2 Supervisory board

The Code sets out the tasks of the **supervisory board** which are as follows:

> '…to advise regularly and supervise the Management Board in the management of the enterprise. It must be involved in decisions of fundamental importance to the enterprise.'

It also sets out the role of the supervisory board in the **appointment and dismissal of members of the management board**, and states that it should implement a long-term **succession policy**.

The **Chairman** of the supervisory board should:

- **Co-ordinate** the work of the supervisory board and chair its meetings
- Head the committee that handles the **contracts of the management board**
- Regularly maintain **contact** with the management board, particularly the chairman

The supervisory board should set up relevant **expert committees**, for example, remuneration and audit committees.

The supervisory board should be composed of members who, as a whole, have the required **knowledge, abilities and expert experience** to properly complete their tasks and are sufficiently independent.

Compensation (**remuneration**) of the supervisory board is set by the **general meeting**.

Members of the supervisory board are also required to **avoid conflicts of interest** and inform the board of them if they arise.

The board itself is asked to **examine its own efficiency** on an annual basis.

4.3 Relationship between the management and supervisory boards

The management board should make disclosures without delay about **new facts**, **individual share holdings**, and **financial information**.

Attention

> Should you want to look at the German Corporate Governance Code in more detail, it is available in various languages, including English, at www.corporate-governance-code.de

5 Legal regulation of corporate governance

FAST FORWARD

A large part of the regulations which we have covered since Chapter 9 relates directly or indirectly to regulation by statute of **corporate governance**.

5.1 Company law

Some provisions of the Act cover the same or similar ground as the Combined Code.

(a) **Members' agreement** is required for directors' notice periods under service contracts of more than two years. In the Combined Code, any such period longer than one year initially must reduce quickly to one year or less.

(b) A **general meeting** is required to remove an auditor or a director.

(c) At least **21 days'** notice must be given to shareholders of a listed company's AGM.

(d) Listed companies can put the results of a poll at a meeting on their **websites**.

In terms of **clarifying relations** between directors, shareholders and auditor, the Companies Act also seeks to support good corporate governance in quoted companies by:

(a) **Ensuring** that a **company's constitution** is contained just in the articles plus company resolutions. There are different model articles available for different types of company so this should help to avoid confusion

(b) Providing that **company directors** must be at least **16** years of age

(c) Providing that companies must have at least **one natural person** as a director

(d) **Codifying directors' duties** to their company

(e) **Revising** and **clarifying rules** on **loans** to directors

(f) Making **directors' service agreements** available to members

(g) **Extending** and **clarifying** the definition of the people a director is deemed to be 'connected' to

(h) Clarifying the procedure by which members may bring **actions** against a director or former director for breach of duty

(i) Allowing shareholders with at least **5%** of a company's shares to call for an independent report on a poll vote

(j) Requiring auditors to **disclose fees** paid for non-audit services

(k) Allowing the auditor of a listed company to **report** on resignation

5.2 State regulation of corporate behaviour

FAST FORWARD

The Financial Services Authority (FSA) is the **regulator of the financial services industry**, **company markets** and **share exchanges** in the UK.

In the UK, state regulation of corporate behaviour is effected through the Financial Services Authority (FSA), which regulates company markets, share exchanges and the financial services industry in the UK.

The FSA is **not a government agency**. It is a private company limited by guarantee, with HM Treasury as the guarantor. It is financed by the financial services industry. The Board of the FSA is appointed by the UK Government Treasury Department.

The FSA:

- Is the **authorising** body for those carrying on regulated activities
- Is the **regulator of exchanges and clearing houses** operating in the UK
- **Approves companies** for listing in the UK
- Is a **rule-making body**
- Undertakes **supervision**
- Has powers of **enforcement**

The FSA has four objectives:

- To **maintain confidence** in the UK financial system
- To **promote public understanding** of the financial system
- To secure a degree of **protection for consumers** whilst recognising their own responsibilities
- To **reduce the scope for financial crime**

The FSA is the **Listing Authority** in the UK. This means that it supervises the rules which listed companies are required to follow. We are also interested in the role the FSA plays in relation to **company investigations**, particularly in relation to market abuse, insider dealing and money laundering.

5.3 Company investigations

FAST FORWARD

The FSA has wide powers to **investigate suspicions** of **certain offences**, such as **money laundering**, **insider dealing** and **market abuse**.

The FSA is authorised to carry out **company investigations** to investigate suspicions of:

- Market abuse
- Misleading statements and practices
- Insider dealing
- Breaches of the Listing Rules
- Suspicions of money laundering

It **shares power** to investigate companies with the Government, which also carries out investigations in relation to the **liquidation of companies**.

Exam focus point

Exam questions often focus on the offences of insider dealing and money laundering which we shall look at in the final chapter of this Study Text, as they are criminal offences. For now, you should bear in mind that the FSA has a significant role to play in policing and punishing those crimes. We shall look in more detail here at the civil offence of market abuse.

5.4 The Sarbanes–Oxley Act 2002

In some jurisdictions, most notably the **US**, the approach taken to corporate governance has been overwhelmingly statutory rather than being based on extra–legal codes of practice. In 2002 the Public Company Accounting Reform and Investor Protection Act, commonly called **Sarbanes-Oxley**, **SOX** or **SarBox**, was passed. This was in response to several major failures of corporate governance and accounting, including Enron, Tyco and WorldCom. These led to a serious loss of public trust in accounting and reporting practices in particular.

The most common transgressions of good corporate governance in the US before Sarbox can be identified as follows:

- **Directors' remuneration** being **grossly disproportionate** to the company's results
- Promotion of **share issues** on the basis of **questionable** or **unproven** business concepts
- **Misuse** of company funds

- **Insider dealing** in company shares, particularly by managers exercising share options that reward short-termism (that is, acting to achieve good results in the short term at the expense of long term success);
- **Misrepresentation** of the true earnings and financial condition of some companies; and
- **Obstructing justice** by concealing activities or destroying evidence.

The people who could be identified as being to blame for these transgressions were:

- **Passive**, **non-independent** boards of directors
- **Chief executives** and **senior managers** with serious conflicts interest between their own and their company's interests
- **Biased** and **non-independent investment analysts** and **fund managers**
- **Non-independent audit firms**; and
- **Regulators** not paying enough attention to the **systemic conflicts** of interest at the core of poor corporate governance

The core problem was that non-performing managers, directors and auditors, acting in a **fiduciary position** as agents, were not being held accountable to the shareholders as principals. Corporate governance should aim to guarantee performance excellence by management and the board of directors when performing their agency duties for shareholders.

The Act established **new** or **enhanced standards** for all US public company boards and senior managers, and for audit firms.

The Act:

- **Established** a new **quasi-public agency**, the Public Company Accounting Oversight Board (PCAOB)
- **Required** that **public companies** evaluate and **disclose** the effectiveness of their internal controls as they relate to financial reporting in the form of an internal control report
- **Required** that **independent auditors** for public companies '**attest**' or **agree** to such disclosure
- **Required** that **certain financial information** concerning material changes in the company's financial condition or operations should be disclosed more quickly
- **Required** that **financial reports** should be **personally certified** by chief executive officers (CEOs) and chief financial officers (CFOs) as being free from misrepresentation
- **Banned external auditors** from undertaking certain types of work for audit clients
- **Required** the **company's audit committee** to **pre-certify** all other types of non-audit work to be undertaken by the external audit firm
- **Required** that **companies listed** on stock exchanges should have **fully independent audit committees** overseeing the relationship between the company and its auditor
- **Banned** most **personal loans** to any executive officer or director
- **Accelerated reporting** of dealing by insiders
- **Prohibited deals** by insiders during certain reporting periods
- **Enhanced criminal** and **civil penalties** for violations of the law on share issues
- **Enhanced criminal penalties** for **altering**, **destroying**, **mutilating** or **concealing any document** with the intent of impairing its use in an official proceeding
- **Set longer maximum jail sentences** and **larger fines** for executives who knowingly and willfully misstate financial statements
- **Protected employees** who '**blow the whistle**' on problems in the company, allowing corporate fraud whistle-blowers to be compensated for loss of office and so on

Chapter Roundup

- Corporate governance is simply a term used for **the way that companies** (corporate) **are run and operated** (governed).
- There are many different **stakeholders** in most companies.
- The stakeholders most closely involved in corporate governance are the **directors** (the managers of the company) and the **shareholders** (who have some ultimate controls in general meeting).
- **Directors** must prepare financial statements for **shareholders annually**, and these are independently audited to provide an objective check on the directors.
- At the AGM the shareholders can exercise their **ultimate control**.
- Following high-profile **corporate failures**, corporate governance codes set out best practice.
- Whether their status is down to voluntary or statutory rules, there are certain aspects of governance, or **'governance structures'** which are generally acceptable.
- The UK, US and many other countries have a **unitary board system**, where there is one board to run a company.
- In Germany and some other countries, a supervisory board system is used. This means that there is a **management board to run the company** and a **supervisory board to oversee** the management board.
- In practice, the **principles of independence and verification behind both the unitary and the dual systems are increasingly growing** closer. **Both systems face similar problems** in terms of finding **suitably qualified people** to undertake supervisory roles and to be an **independent** voice in a company.
- Guidance on the composition of a board in the UK is given in the **Combined Code on Corporate Governance**. This sets out a series of principles about how boards should be composed: effective board collectively responsible for the success of the company; balance of non-executive and executive directors; division of responsibility between the chief executive and the chairman.
- The **German Corporate Governance Code** gives guidance about the composition and role of management and supervisory boards.
- A large part of the regulations which we have covered since Chapter 9 relates directly or indirectly to regulation by statute of **corporate governance**.
- The Financial Services Authority (FSA) is the **regulator of the financial services industry**, **company markets** and **share exchanges** in the UK.
- The **FSA** has wide powers to **investigate suspicions** of **certain offences**, such as **money laundering**, **insider dealing** and **market abuse**.

Quick Quiz

1 Complete the definition.

The Cadbury report defined ………………. …………………….. as 'the system by which companies are directed or controlled'.

2 Which of the following criteria might indicate that a director was not independent?

- Being an employee of the group in the previous five years
- Being a qualified accountant
- Having been employed by the company's audit firm ten years ago
- Representing a significant shareholder
- Having served on the board for six years

3 Give five examples of what the Aufsichtsrat in a German company does.

(1) ....

(2) ....

(3) ....

(4) ....

(5) ....

4 According to the German Corporate Governance Code, the Supervisory board should examine its own efficiency on an annual basis.

True ☐

False ☐

5 Name three criticisms of the unitary board approach.

(1) ....

(2) ....

(3) ....

Answers to Quick Quiz

1 **Corporate governance**

2 Being an employee in the last five years, representing a significant shareholder

3 See the full list in Section 2.3.2

4 True. It should examine its own efficiency.

5 (1) Being both a manager and a supervisor is too awkward a task for non-executives
(2) The independence criteria is too difficult to meet
(3) The system does not properly account for representing the needs of employees

Now try the question below from the Exam Question Bank

Number	Level	Marks	Time
Q20	Examination	10	18 mins

BPP LEARNING MEDIA

Fraudulent behaviour

19

Topic list	Syllabus reference
1 Financial crime	H2(a-d)
2 Insider dealing	H2(a)
3 Market abuse	H2(c)
4 Money laundering	H2(b)
5 Criminal activity relating to companies	H2(c)

Introduction

We introduced the concept of criminal law in Chapter 1. In this Chapter, we shall look specifically at some **financial crimes** and the **international measures** that have been put into place to combat them.

Insider dealing is a statutory offence. It has proved difficult to convict people of the crime of insider dealing, hence the introduction of the civil wrong of market abuse, discussed in Chapter 18. We shall set out the law on insider dealing and its effectiveness in Section 2.

The issue of **money laundering** is, in particular, a highly topical issue. Money laundering is the process of 'legalising' funds raised through crime. Money laundering crosses national boundaries and it can be difficult to enforce the related laws. International cooperation is required.

We shall look at some of the organisations and model laws that have been set up to deal with the international crime of money laundering.

Finally we shall look at offences in relation to insolvent companies.

Study guide

		Intellectual level
H2	**Fraudulent behaviour**	
(a)	Recognise the nature and legal control over insider dealing	2
(b)	Recognise the nature and legal control over money laundering	2
(c)	Discuss potential criminal activity in the operation, management and winding up of companies	2
(d)	Distinguish between fraudulent and wrongful trading	2

Exam guide

International financial crime is highly examinable, in both types of question. The examiner has recently published an article on money laundering.

1 Financial crime

FAST FORWARD

Crime is **conduct prohibited by the law**. Financial crime can be international in nature, and there is a need for international cooperation to prevent it.

We introduced the concept of **crime** in Chapter 1. Remember, it is **conduct prohibited by the law**.

Law tends to be organised on a **national basis**. However, as we shall see later in this chapter, some crime, particularly money laundering, is perpetrated **across national borders**. Indeed, the international element of the crime contributes to its success.

Particularly with regard to money laundering, international bodies are having to **cooperate** with one another in order to control financial crimes which spreads across national boundaries.

1.1 Example: international financial crime

Money laundering is a crime in Country A but not in Country B. Money laundering can be effected legally in Country B and the proceeds returned to Country A. Hence Country A cannot prosecute for the crime of money laundering, which has not been committed within its national boundaries.

PER alert

PER 1 requires you to demonstrate application of professional ethics, values and judgement. Prevention of financial crime is an important part of this.

2 Insider dealing

FAST FORWARD

Insider dealing is the UK statutory offence of dealing in securities while in possession of inside information as an insider, the securities being price affected by the information.

In the UK the **Criminal Justice Act 1993** (CJA) contains the rules on **insider dealing**. It is regarded and treated as a crime since a few people are enriched at the expense of the reputation of the stock market and the interests of all involved in it.

2.1 What is insider dealing?

Key term

Insider dealing is dealing in securities while in possession of inside information as an insider, the securities being **price-affected** by the information.

To prove insider dealing, the prosecution must prove that the possessor of inside information (under s 52 CJA):

- **Dealt** in **price-affected securities** on a regulated market, or
- **Encouraged another** to **deal** in them on a regulated market, or
- **Disclosed** the **information** other than in the proper performance of their employment, office or profession

2.1.1 Dealing

Dealing is **acquiring or disposing** of or **agreeing** to **acquire** or **dispose** of relevant securities whether **directly** or **through an agent** or nominee or a person acting according to direction: s 55 CJA.

2.1.2 Encouraging another to deal

An offence is also committed if an individual, having information as an insider, **encourages another person** to deal in price-affected securities in relation to that information, they must **know** or have reasonable cause to believe that **dealing** would **take place**.

It is irrelevant whether:

- The person encouraged realises that the securities are price-affected securities
- The **inside information is given** to that person. For example, a simple recommendation to the effect that 'I cannot tell you why but now would be a good time to buy shares in Bloggs plc' would infringe the law
- **Any dealing takes place**, the offence being committed at the time of encouragement

2.2 Securities covered by the Act

Securities include shares, debt securities and warranties: s 54 CJA.

2.3 Inside information

Key term

Inside information is **'price sensitive information'** relating to a **particular issuer** of **securities** that are price-affected and not to securities generally: s 56 CJA.

Inside information must, if made public, be likely to have a **significant effect on price** and it must be **specific or precise**. Specific would, for example, mean information that a takeover bid would be made for a specific company; precise information would be details of how much would be offered for shares.

2.4 Insiders

Under s 57 a person has information as a **primary insider** if it is (*and* he **knows** it is) inside information, and if he has it (*and* **knows** he has) from an inside source:

- Through being a **director**, **employee** or **shareholder** of an issuer of securities
- Through access because of **employment**, **office** or **profession**

If the direct or indirect source is a person within these two previous categories then the person who has inside information from this source is a **secondary insider**.

2.5 General defences

Under s 53, the individual has a defence regarding dealing and encouraging others to deal if they can show that:

- They did **not expect** there to be a **profit** or avoidance of loss
- They had **reasonable grounds** to **believe** that the information had been **disclosed widely** enough to ensure that those taking part in the dealing would be prejudiced by having the information
- They would have **done** what they did **even** if they did not have the **information**, for example, where securities are sold to pay a pressing debt

Defences to disclosure of information by an individual are that:

- They **did not expect** any person to deal
- Although dealing was expected, **profit** or **avoidance of loss** was **not expected**

2.6 'Made public'

This term is not exhaustively defined by the statute, leaving final determination to the Court. Information **is** made public if:

- It is **published** under the rules of the regulated market, such as the Stock Exchange
- It is in **public records**, for example, notices in the *London Gazette*
- It can **readily be acquired** by those likely to deal
- It is derived from public information

Information **may** be treated as made public even though:

- It can **only** be **acquired** by **exercising diligence** or expertise (helping analysts to avoid liability).
- It is **communicated only** to a **section** of the **public**.
- It can be **acquired** only by **observation**.
- It is **communicated only** on **payment of a fee** or is published outside the UK.

2.7 Penalties

Maximum penalties given by the statute are **seven years' imprisonment** and/or an **unlimited fine**. Contracts remain valid and enforceable at civil law.

2.8 Territorial scope

The offender or any professional intermediary must be **in the UK** at the time of the offence or the market must be a UK regulated market.

2.9 Problems with the laws on insider dealing

FAST FORWARD

The law on insider dealing has had some limitations, and **new offences**, such as **market abuse**, have been brought in to reduce security related crime.

The courts may have problems deciding whether information is **specific** or **precise**. The statute states that information shall be treated as relating to an issuer of securities not only when it is **about the company** but also where it may **affect the business prospects** of the company.

The requirement that price-sensitive information has a **significant effect on price** limits the application of the legislation to fundamental matters. These include an impending takeover, or profit or dividend levels which would be out of line with market expectations.

As a result the concept of **'market abuse'** was introduced in the UK in 2000. This was partly in response to the perceived ineffectiveness of the insider dealing provisions in the Criminal Justice Act 1993. Insider dealing is just one type of market abuse.

Exam focus point

Future exam questions may be set jointly on insider dealing and market abuse. If this is the case, remember that insider dealing is a criminal offence, while most forms of market abuse are a civil matters.

3 Market abuse

FAST FORWARD

Market abuse relates to behaviour which amounts to abuse of a person's position regarding the stock market.

Key term

Market abuse is behaviour which satisfies one or more of the prescribed conditions likely to be regarded as a failure on the part of the person or persons concerned to **observe the standard of behaviour reasonably expected of a person in his position in relation to the market**.

The offence of **market abuse** under the Financial Services and Markets Act 2000 complements legislation covering insider dealing by providing a civil law alternative. The FSA has issued a **Code of Market Conduct,** which applies to any person dealing in certain investments on recognised exchanges and which does not require proof of intent to abuse a market.

The FSA has statutory civil powers to impose unlimited fines for the offence of **market abuse. It also has statutory** powers to require information, and requires anyone to co-operate with investigations into market abuse.

Market abuse could consist of:

(a) **Misuse of information**, for example, knowingly buying shares in a takeover target before a general disclosure of the proposed takeover. This is similar to insider dealing.

(b) **Market distortion**, which is interfering with the normal process of share prices moving up and down in accordance with supply and demand for the shares.

(c) **Creating a false or misleading impression** about supply and demand or prices and values of investments. An example might be posting an inaccurate story on an internet bulletin board.

(d) Recklessly making a statement or forecast that was **misleading, false or deceptive**.

(e) Engaging in a **misleading course of conduct** for the purpose of inducing another person to exercise or refrain from exercising rights in relation to investments.

Remarks made by the judge when sentencing in *R v Bailey 2005* suggested that directors will be held personally responsible for public announcements in order to ensure the integrity of the market is preserved and the public protected.

4 Money laundering

4.1 What is money laundering?

FAST FORWARD

Money laundering is the attempt to make money from criminal activity appear legitimate.

Key term

Money laundering is the term given to attempts to make the proceeds of crime appear respectable.

It covers any activity by which the apparent source and ownership of money representing the proceeds of income are changed so that the money appears to have been obtained legitimately.

Money laundering is a crime that is against the interests of the state, and it is associated with drug and people trafficking in particular, and with organised crime in general.

Money laundering legislation in the UK has been influenced on a number of different Acts of Parliament:

- Drug Trafficking Offences Act 1986
- Criminal Justice Act 1993
- Terrorism Act 2000
- Anti-terrorism Crime and Security Act 2001
- Proceeds of Crime Act 2002 (PCA)

4.2 Categories of criminal offence

FAST FORWARD

In the UK, there are various offences relating to money laundering, including **tipping off** a money launderer (or suspected money launderer) and **failing to report** reasonable suspicions.

There are **three categories of criminal offences** in the Proceeds of Crime Act.

(a) **Laundering**: acquisition, possession or use of the proceeds of criminal conduct, or assisting another to retain the proceeds of criminal conduct and concealing, disguising, converting, transferring or removing criminal property: ss 327-329 PCA. This relates to its nature, source, location, disposition, movement or ownership of the property.

(b) **Failure to report** by an individual: failure to disclose knowledge or suspicion of money laundering (suspicion is more than mere speculation, but falls short of proof or knowledge).

(c) **Tipping off**: under s 333 CJA, disclosing information to any person if disclosure may prejudice an investigation into drug trafficking, drug money laundering, terrorist related activities and laundering the proceeds of criminal conduct.

For the purposes of laundering, '**criminal property**' is defined by s 3 CJA as a property which the alleged offender knows (or suspects) constitutes or represents being related to any criminal conduct. This is any conduct that constitutes or would constitute an offence in the UK.

In relation to **laundering**, a person may have a **defence** if they make disclosure to the authorities:

- As soon as possible after the transaction
- Before the transaction takes place

Alternatively, they may have a defence if they can show there was a reasonable excuse for not making a disclosure.

In relation to **failure to report**, the person who suspects money laundering must disclose this to a nominated money laundering reporting officer within their organisation, or directly to the National Criminal Intelligence Service (NCIS). This has responsibility in the UK for collecting and disseminating information related to money laundering and related activities. The nominated money laundering reporting officer in an organisation acts as a filter and notifies NISC too.

In relation to **tipping off**, this covers the situation when a person making a disclosure to NCIS also tells the person at the centre of their suspicions about the disclosure. There is a **defence** to the effect that the person did not know that tipping off would prejudice an investigation.

4.3 Penalties

The law sets out the following penalties in relation to money laundering:

(a) 14 years' imprisonment and/or a fine, for knowingly assisting in the **laundering** of criminal funds

(b) 5 years' imprisonment, for failure to report knowledge or the suspicion of money laundering

(c) 5 years' imprisonment for 'tipping off' a suspected launderer. The suspected launderer must not be alerted

Question — Money laundering

Why should a professional adviser not give a warning to a client whom he suspects of money laundering?

Answer

Tipping off a suspected money launderer is an offence. Alerting the suspect would be likely to hamper any subsequent investigation by the authorities.

The money laundering process usually involves three phases:

- **Placement** – this is the initial disposal of the proceeds of the initial illegal activity into apparently legitimate business activity or property
- **Layering** – this involves the transfer of monies from business to business or place to place to conceal the original source
- **Integration** – having been layered, the money has the appearance of legitimate funds

For accountants, the most worrying aspect of the law on money laundering relates to the offence of '**failing to disclose**'. It is relatively straightforward to identify actual 'knowledge' of money laundering, and therefore of the need to disclose it, but the term 'suspicion' of money laundering is not defined. The nearest there is to a definition is that suspicion is more than mere speculation but falls short of proof or knowledge. It is a question of judgement.

4.4 The role of the Financial Services Authority

The **FSA Handbook** and the **Joint Money Laundering Steering Group (JMLSG)** guidance include similar, and therefore parallel but separate, rules and guidance. Investment firms (that is, firms who sell financial services or shares) are required to have:

(a) **Control systems** in place to monitor possible money laundering activities.

(b) A **Money Laundering Reporting Officer (MLRO)** who is responsible for the oversight of the anti-money laundering activities.

(c) **Internal reporting procedures**. Staff must be able to identify suspicious transactions, understand reporting procedures, and be able to notify the MLRO of any person who they suspect of engaging in money laundering.

(d) **Adequate records** such as:

  (i) A copy of the evidence of identity obtained

  (ii) A record of where a copy of the identity evidence can be obtained

  (iii) Procedures for internal and external reporting

  (iv) Evidence of an applicant's identity must be retained for five years from the end of the firm's relationship with the client, or

  (v) Money laundering training given to all staff who handle transactions (or who manage others who are responsible for handling transactions) that may involve money laundering

Although investment firms may be particularly at risk of being involved with clients who are seeking to launder money, **methods used** for laundering such dirty money **can be extremely complex**. They may involve **trusts, companies** (both offshore and onshore) and could involve the use of relatively complex bank instruments.

Therefore **all companies**, their **managers** and their **advisers need to be aware** of the issue of money laundering and not fall foul of the regulations.

There is a **legal requirement** for organisations to take the following actions.

- To set up procedures and establish accountabilities for senior individuals to take action to prevent money laundering
- To educate staff and employees about the potential problems of money laundering
- To obtain satisfactory evidence of identity where a transaction is for more than €15,000 or £10,000
- To report suspicious circumstances (according to the established procedures)
- Not to alert persons who are or might be investigated for money laundering
- To keep records of all transactions for five years

Exam focus point

You must be clear of how this guidance seeks to prevent or minimise money laundering.

4.5 Vienna Convention

FAST FORWARD

Various **international bodies** have set out **international guidelines** relating to money laundering, because it is an international issue. The guidance includes recommendations about criminalising money laundering, international co-operation to investigate money laundering, seizing the proceeds of crime and undertaking proceedings against money launderers.

The **Vienna Convention** (its full name is The UN Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances) was signed in 1988 and came into effect in 1990.

It was the first international agreement to join together to stop the international effects of money laundering. **Money laundering** was made a **criminal offence**. This preceded each State taking national measures to put this into effect (hence, in the UK, money laundering laws).

The key factor in making an international agreement on money laundering work are encouraging **mutual assistance** in investigation and extradition. The UN has produced further treaties to assist countries work with one another on these matters.

An independent body was set up to oversee implementation of the themes of the Vienna Convention. This is **FATF**, which we discuss below. One of the key objectives of FATF is to ensure countries ratify and implement the Vienna Convention. Many of the themes in the Convention are explored in FATF's 40 recommendations, summarised below.

4.6 Financial Action Task Force on Money Laundering (FATF)

The Financial Action Task Force on Money Laundering (FATF) is an inter-governmental body made up of 29 states and two international organisations (the European Commission and the Gulf Cooperation Council).

The **aims** of FATF are to:

- Develop and promote **policies to combat money laundering**
- **Prevent proceeds being used** in future criminal activities and affecting legitimate economic activities

FATF has developed **40 recommendations** for countries to adopt in the fight against money laundering.

These recommendations are set out in principle form, because FATF recognises that **all countries are different** and therefore cannot take identical measures.

The first recommendation is that all countries should **take steps to ratify and fully implement the UN's Vienna Convention**.

Another general point made in the recommendations is that **countries should assist each other** in money laundering investigations and prosecutions, including extraditions if necessary. This emphasises the **international nature of the problem**.

Another interesting point in the recommendations is the suggestion that ideally, **corporations**, as well as their employees, should be **subject to criminal liability** when money laundering is proven. This is not the case in the UK.

FATF 40 RECOMMENDATIONS (extracts)	
General framework	• Countries should ratify the Vienna Convention • Financial institution secrecy laws should not stop implementation of the recommendations • There should be multilateral co-operation and mutual legal assistance
Role of national legal systems	• Countries should take steps to criminalise money laundering • Countries should take steps to enable authorities to confiscate laundered money
Role of the financial system	• The recommendations should not apply only to banks but to other financial institutions • Financial institutions (FIs) should not keep anonymous accounts or accounts in obviously fictitious names • FIs should take reasonable measures to obtain information about the true identity of the persons on whose behalf the account is being opened • FIs should maintain necessary records for at least 5 years, to assist international investigations • FIs should pay attention to any complex transactions and report suspicions of suspect activity promptly • FIs and their employees should be exempt from laws preventing disclosures • FIs should develop programmes against money laundering • Supervisory authorities should ensure that FIs have sufficient programs in place to counter money laundering
International co-operation	• Nations should exchange general information and information relating to suspicious transactions • They should also cooperate in confiscation, mutual assistance and extradition

Attention!

You can find the full version of FATF's 40 Recommendations at www1.oecd.org/fatf.

4.7 Council of Europe Convention 1993

Attention!

You may want to refer back to Chapter 2 to remind yourself what the Council of Europe is. Remember, the Council proposes Conventions which can be ratified both by its members and by other nations.

The CoE Convention contains many similar provisions to the FATF recommendations above. It contains two key elements:

- Provisions to be made at a **national level**
- Actions to be taken at an **international level**

4.7.1 National level

The Convention sets out the following legislative or other measures that States should adopt at a national level:

- To **confiscate proceeds** of money laundering
- To **trace property** liable to confiscation
- To require banks and other financial institutions to **provide information**
- To provide **legal remedies** so as to preserve the legal rights of parties affected by above measures
- To establish **offences** under domestic law which may be committed internationally (such as illegal transfer of property or concealment of true ownership of property)

4.7.2 International level

It also sets out principles of international co-operation:

- Parties shall **co-operate** to the widest extent in relation to investigations and proceedings
- Parties shall assist other parties in **investigations** on request
- Parties shall pass on **information** without prompting when it may assist in investigations
- Parties shall carry out **confiscation orders** in their country on request from other parties

The Convention sets out a number of **grounds for refusing to cooperate**, for instance, if it would go against the national law of the requested party.

Attention!

The full text of the Convention (CoE Convention Number 141) can be found at www.conventions.coe.int.

Question — **Money laundering**

Why is money laundering a difficult international issue?

Answer

Money laundering can be carried out effectively across national boundaries. It is difficult to prevent this when money laundering is a criminal offence in certain countries and not in others. It is also difficult to co-operate internationally on some matters as different countries have different legal systems and therefore methods of carrying out such activities. Extradition can be a difficult process as well.

The UN's Vienna Convention 1998 deals with some of these issues. It criminalises money laundering and encourages international assistance in fighting money laundering. The UN have since set out two further Conventions on legal practices such as extradition to make the process easier.

However, one problem inherent in money laundering is that if every nation does not sign up to the Convention or put systems in place to prevent it, there will still be places in the world where money laundering can be carried out and where it is difficult to police.

5 Criminal activity relating to companies

In Chapter 15 we saw a number of potential crimes in relation to the operation and management of companies, and the way in which these can be investigated.

With regard to the **operation and management of companies**, a company as a legal person may be prosecuted for many different types of crime. However, this is nearly always in conjunction with the directors and/or managers of the company. Companies have been prosecuted for manslaughter (unsuccessfully), fraud, and breaches of numerous laws for which fines are stated as being punishment, such as health and safety laws.

Prosecutions are often brought against directors of **insolvent** companies for fraudulent trading and wrongful trading.

5.1 Criminal offences in relation to winding up

FAST FORWARD

Criminal offences in relation to **winding up** include: making a declaration of solvency without reasonable grounds; fraudulent trading; wrongful trading.

The law seeks to **protect creditors** who may be disadvantaged by the company being liquidated. **Directors** can be found guilty of various criminal offences if they try to **deceive** creditors, and, in some cases, even if they do not attempt to deceive creditors, but the effect is the same as if they had.

5.2 Declaration of solvency

As discussed previously, a winding up can only be a members' voluntary winding up if the company is solvent. If the company is not solvent, the creditors are far more involved in the winding up process. In order to carry out a members' voluntary winding up, the directors have to file a **declaration of solvency**.

It is a **criminal offence** punishable by fine or imprisonment for a director to make a **declaration of solvency without** having **reasonable grounds** for it. If the company proves to be insolvent, he will have to justify his previous decision, or be punished.

5.3 Fraudulent trading

This criminal offence under the Companies Act (s 993) occurs where the business of a company in liquidation has been carried on with **intent to defraud creditors** or for any fraudulent purpose. Offenders are liable to imprisonment or a fine.

There is also a **civil offence** of the same name under s 213 of the Insolvency Act 1986. Under this offence, courts may declare that **any persons** who were knowingly parties to carrying on the business in this fashion shall be liable for the debts of the company.

Various rules have been established to determine **what is fraudulent trading**:

(a) Only persons who **take the decision** to carry on the company's business in this way or play some active part are liable.

(b) **'Carrying on business'** can include a single transaction and also the mere payment of debts as distinct from making trading contracts.

(c) As in civil cases, the criminal offence of fraudulent trading relates not only to **defrauding creditors**, but also to **carrying on a business for the purpose of any kind of fraud**: *R v Kemp 1988*.

If the liquidator considers that there has been fraudulent trading he should apply to the court for an order that those responsible are liable to make good to the company all or some specified part of the **company's debts**.

5.4 Wrongful trading

The problem which faced the creditors of an insolvent company before the introduction of '**wrongful trading**' was that it was exceptionally difficult to prove the necessary fraud. Therefore a further civil liability for 'wrongful trading' was introduced, which means that the director will have to make such contribution to the company's assets as the court sees fit.

Directors will be liable if the liquidator proves the following.

(a) The director(s) of the insolvent company **knew**, or **should have known**, that there was **no reasonable prospect** that the **company** could **have avoided going into insolvent liquidation**. This means that directors cannot claim they lacked knowledge if their lack of knowledge was a result of failing to comply with Companies Act requirements, for example preparation of accounts: *Re Produce Marketing Consortium 1989* (see below).

(b) The director(s) did not take sufficient steps to minimise the potential loss to the creditors.

Directors will be deemed to know that the company could not avoid insolvent liquidation if that would have been the conclusion of a **reasonably diligent person** with the **general knowledge**, **skill and experience** that might reasonably be expected of a person carrying out that particular director's duties. If the director has greater than usual skill then he will be judged with reference to his own capacity.

5.5 Other offences in relation to winding up

We saw in Chapter 17 that it is a criminal offence for directors to make a **false declaration of solvency** during a liquidation – further offences in relation to winding up include the following.

5.5.1 Acting as a director whilst disqualified

S 15 of the **Company Directors Disqualification Act 1986** makes a person who **acts as a director whilst disqualified** personally liable for the company's debts. Directors of insolvent companies may be disqualified under the Act if the court deems they are unfit to be involved in the management of a company.

5.5.2 Phoenix companies

Phoenix companies are created by directors of insolvent companies as a **method of continuing their business**. Very often they have similar names as (or similar enough to suggest an association with) the insolvent company. S 216 of the Insolvency Act 1986 makes it a **criminal offence** where a director **creates such a company within five years of the original company being liquidated**. The person is liable for a fine or imprisonment. S 217 also makes a person who creates such a company personally liable for its debts.

5.5.3 Fraud and deception

S 206 of the Insolvency Act 1986 makes it a criminal offence to **conceal** or **fraudulently remove company assets** or **debt** – including falsifying records. It is also an offence to **dispose of property** that was **acquired on credit** that has **not been paid** for.

5.5.4 Defrauding creditors

Once a winding up commences, s 207 of the Insolvency Act 1986 makes it an offence to make a **gift** of, or **transfer company property**, unless it can be proved there was no intent to defraud creditors.

5.5.5 Misconduct during a liquidation

A company officer may be liable for a number of offences due to their misconduct. These include:

- Not identifying company property to the liquidator
- Not delivering requested books and papers to the liquidator
- Not informing the liquidator if identified debts do not turn out to be debts

5.5.6 Falsification of company books

The **destruction**, **mutilation**, **alteration** or **falsification** of **company books** is an offence under s 209 of the Insolvency Act 1986.

5.5.7 Omissions

It is an offence under s 210 of the Insolvency Act 1986 to **omit material information** when making statements concerning a company's affairs.

5.6 Examples: offences in relation to winding up

The standard expected of a listed company director would be higher than for the director of a small owner-managed private company.

Halls v David and Another 1989

The facts: The directors sought to obtain relief from liability for wrongful trading by the application of what is now S 1157 Companies Act 2006. This stated that in proceedings for negligence, default, breach of duty or breach of trust against a director, if it appears that he has acted honestly and reasonably the court may relieve him wholly or partly from liability on such terms as it sees fit.

Decision: S 1157 Companies Act 2006 is not available to excuse a director from liability under s 214, Insolvency Act 1986.

Re Produce Marketing Consortium Ltd 1989

The facts: Two months after the case above, the same liquidator sought an order against the same directors. This time they should contribute to the company assets (which were in the hands of the liquidator) since they had been found liable for wrongful trading.

Decision: The directors were jointly and severally liable for the sum of £75,000 plus interest, along with the costs of the case. The judge stated that the fact that wrongful trading was not based on fraud was not a reason for giving a nominal or low figure of contribution. The figure should, however, be assessed in the light of all the circumstances of the case.

This case was significant for creditors, since the assets available for distribution in a winding up will (potentially) be much increased by a **large directors' contribution**. It serves as a warning to directors to take professional advice sooner rather than later. The prospect of making a personal contribution may prove much more expensive than winding-up at the appropriate stage.

5.7 Companies Act 2006 offences

The Companies Act 2006 created a **number of offences** in relation to the **management** and **operation** of a company. Some have been mentioned earlier in this text but are included here for reference.

5.7.1 Company records

Company records and **registers**, such as the register of members and records of resolutions **must be kept adequately for future reference**. Officers in default are liable to a fine (s 1135). **Falsification** of **information**, **hiding falsification** or **failing to prevent falsification** are also offences and the wrongdoer is liable to a fine (s 1138).

5.7.2 Accounting records

Where a company fails to **keep adequate accounting records**, every officer who defaults is subject to a fine (s 387). However, they have a **defence** if they **acted honestly** and the **circumstances** surrounding the company's business makes the default **excusable**.

5.7.3 Trading disclosures

Companies are required to disclose **certain information** (such as its name) in **specific locations**. If these disclosures are not made then defaulting officers are criminally liable for a fine and may also be liable for losses under the civil law.

5.7.4 Filing accounts

If a company fails to **file its accounts within the time limit following its year end** then any defaulting officer is liable to a fine (s 451). However they will have a **defence** if they took **reasonable steps** to **ensure the requirements** were **complied with**.

5.7.5 False information

Under s 463, officers are liable for making **false disclosures** in relation to the **directors' report**, **directors' remuneration report** and **summary financial statements** based on those reports.

An officer is also liable under s 501 for **providing false** or **misleading information to an auditor**. Punishment is either imprisonment or a fine.

5.7.6 Annual return

Officers are liable for a fine under s 858 for **failing to deliver the company's annual return by the return date**.

5.8 The Fraud Act 2006

The **Fraud Act 2006,** to which directors and secretaries are subject, created a **single offence of fraud**, which a person can commit in three different ways by:

- **False representation**: dishonestly making a false representation of fact or law, intending thereby to make a gain for himself or another, or to cause another party loss, or to expose that party to the risk of making loss
- **Failure to disclose information when there is a legal duty to do so**: dishonestly failing to disclose to another person information which he is under a legal duty to disclose, thereby intending to make a gain for himself or another, or to cause another party loss or expose that party to the risk of making loss
- **Abuse of position**: occupying a position in which he is expected to safeguard, or not to act against, the financial interest of another person, and dishonestly abusing that position, thereby intending to make a gain for himself or another, or to cause another party loss or expose that party to the risk of suffering loss.

Chapter Roundup

- **Crime** is **conduct prohibited by the law**. Financial crime can be international in nature, and there is a need for international cooperation to prevent it.
- **Insider dealing** is the UK statutory offence of dealing in securities while in possession of inside information as an insider, the securities being price affected by the information.
- The law on insider dealing has had some limitations, and **new offences**, such as **market abuse**, have been brought in to reduce security related crime.
- **Market abuse** relates to behaviour which amounts to abuse of a person's position regarding the stock market.
- **Money laundering** is the attempts to make money from criminal activity appear legitimate.
- In the UK, there are various offences relating to money laundering, including **tipping off** a money launderer (or suspected money launderer) and **failing to report** reasonable suspicions.
- Various **international bodies** have set out **international guidelines** relating to money laundering, because it is an international issue. The guidance includes recommendations about criminalising money laundering, international cooperation to investigate money laundering, seizing the proceeds of crime and undertaking proceedings against money launderers.
- **Criminal** offences in relation to **winding up** include: making a declaration of solvency without reasonable grounds; fraudulent trading; wrongful trading.

Quick Quiz

1 Insider dealing is a UK offence.

True ☐

False ☐

2 **Fill in the blanks**.

Inside information is '……. …………. ……………..' relating to a ………… ……….. of **securities** that are price-affected and not to securities generally. It must, if made public, be likely to have a **significant effect on** .... and it must be **specific or precise**.

3 Define money laundering.

4 Which of the following is not a UK offence relating to money laundering?

A Concealing the proceeds of criminal activity
B Tipping off
C Dealing in price affected securities
D Failing to report suspicion of money laundering

5 What is placement?

6 The FATF recommendations suggest that companies, as well as their employees should be liable for money laundering.

True ☐

False ☐

Answers to Quick Quiz

1 True. Insider dealing is a criminal offence.

2 **Inside information** is **'price sensitive information'** relating to a **particular issuer** of **securities** that are price-affected and not to securities generally. It must, if made public, be likely to have a **significant effect on price** and it must be **specific or precise**.

3 **Money laundering** is the term given to attempts to make the proceeds of crime appear respectable.

It covers any activity by which the apparent source and ownership of money representing the proceeds of income are changed so that the money appears to have been obtained legitimately.

4 C. This could be insider dealing, if the person dealing was an insider and was using inside information.

5 Placement is the disposal of the initial proceeds of the illegal activity.

6 True. Both should be liable.

Now try the questions below from the Exam Question Bank

Number	Level	Marks	Time
Q21	Examination	10	18 mins
Q22	Examination	10	18 mins

Exam question and answer bank

1 Sources of law **18 mins**

Describe the main sources of law found in **TWO** of the following:

(a) Common law system
(b) Civil law system
(c) Sharia law system **(10 marks)**

2 Court adjudication or alternative dispute resolution **18 mins**

Compare and contrast court adjudication with alternative dispute resolution, setting out the advantages and disadvantages of each. **(10 marks)**

3 Arbitration agreements **18 mins**

(a) Explain what is meant by an arbitration agreement in the context of the Model Law, and the stipulations that the Model Law makes as to its form and the relevant place of business. **(7 marks)**

(b) Explain the relationship between arbitration proceedings and court proceedings involving two parties who have a written arbitration agreement under the Model Law. **(3 marks)**

(Total = 10 marks)

4 Application of the Convention **18 mins**

Chapter 1 of the UN Convention on the International Sale of Goods covers the Convention's sphere of application.

(a) Explain how Article 1 identifies the parties to a sale of goods contract to which the Convention applies. **(4 marks)**

(b) List the types of contract to which the Convention does and does not apply. **(6 marks)**

(Total = 10 marks)

5 Incoterms **18 mins**

The International Chamber of Commerce has issued standard trade definitions for use in international trade, known as incoterms. Explain the following terms:

(a) FOB **(3 marks)**
(b) CIF **(3 marks)**
(c) EXW **(2 marks)**
(d) CPT **(2 marks)**

(Total = 10 marks)

6 Quality in sales of goods **18 mins**

A and B have entered into a new contract governed by the UN Convention for the sale of rollers by A to B. The contract simply refers to 'rollers' of a particular size; there are no clauses on quality in it. However the contract does state that the rollers are to be used in a process called mangling. Usually in a contract such as this, rollers are just used for basic rolling. Delivery is scheduled for 26 January 20X3, and the correct quantity of rollers is delivered by A to B on 7 January 20X3. Without inspecting them, B puts the rollers into the mangling production process on 19 February 20X3. The rollers are found to be unsuitable for mangling. In the process of diverting them to the rolling production process, 30% of them are wasted. B informs A of the problem on 23 May 20X3, seeking damages for breach of contract, and for the loss of profit on the mangled rollers.

A and B had never dealt with each other before.

Advise A on the likely outcome of the case, including the remedies that may be available to B. **(10 marks)**

7 Payment **18 mins**

In the context of contracts for the international sale of goods, compare, contrast and explain the benefits of:

(a) Bank transfers **(3 marks)**
(b) Bills of exchange **(4 marks)**
(c) Letters of credit **(3 marks)**

(Total = 10 marks)

8 Model law on agency **18 mins**

The UN model law on agency sets out the position where the principal and agent do not agree on which law will apply to the relationship between agent and principal.

Required

Explain the position under the model law when agent and principal do not agree what law will govern their relationship. **(10 marks)**

9 Authority and limited partnerships **18 mins**

(a) What is meant by 'apparent authority' in the context of partnership law? **(5 marks)**

(b) What are the main requirements of a limited liability partnership with regard to formation and publicity of information? **(5 marks)**

(Total = 10 marks)

10 Companies **18 mins**

In relation to companies explain the following:

(a) A public limited company **(3 marks)**
(b) Parent and subsidiary companies **(4 marks)**
(c) A multinational company **(3 marks)**

(Total = 10 marks)

11 Incorporation and promoters — 18 mins

(a) Explain what is meant by the following in company law:

(i) A promoter **(3 marks)**

(ii) A pre-incorporation contract **(3 marks)**

(b) Describe the liability of a promoter on a pre-incorporation contract. **(4 marks)**

(Total = 10 marks)

12 National Hair Brushes — 18 mins

National Hair Brushes plc was incorporated in June 20X6.

Required

(a) The company wishes to trade under the business name 'Wave Oh'. State the statutory requirements with which the company must comply. **(5 marks)**

(b) The directors have received a letter from another company, Lancashire Hair Brushes plc, stating that it was incorporated in 20X5, that its business is being adversely affected by the use of the new company name and demanding that National Hair Brushes plc changes the company name.

Advise National Hair Brushes plc. **(5 marks)**

(Total = 10 marks)

13 Articles — 18 mins

Explain the content and effect of a company's articles of association. **(10 marks)**

14 Shares — 18 mins

(a) What is a company's share capital? **(5 marks)**

(b) Explain the meaning of the following:

(i) Issued capital **(2 marks)**

(ii) Paid up capital **(3 marks)**

(Total = 10 marks)

15 Debentures and charges — 18 mins

In relation to companies' loan capital explain the following terms.

(a) Debenture **(3 marks)**

(b) Fixed charge **(3 marks)**

(c) Floating charge **(4 marks)**

(Total = 10 marks)

16 Issuing shares — 18 mins

Explain the meaning of the following:

(a) The issue of shares at a premium **(5 marks)**

(b) The prohibition on the issue of shares at a discount **(5 marks)**

(Total = 10 marks)

17 Statutory duties **18 mins**

Briefly explain any FIVE of the statutory duties owed by directors to their companies. **(10 marks)**

18 Hydrangea **18 mins**

The directors of Hydrangea plc, a company selling garden furniture, wishes to call an AGM at which the accounts will be approved and all the directors re-elected. It also wishes to change the name of the company to Motormowers plc.

Required

(a) The directors seek your advice on the statutory requirements which apply to the calling of the meeting, the notice of the meeting and to ensure the resolutions gain legal effect when passed. **(5 marks)**

(b) Provide advice to the directors on how the votes of members and proxies should be taken and counted at the meeting. **(5 marks)**

(Total = 10 marks)

19 Company rescue **18 mins**

Explain the corporate rescue provisions of Chapter 11 of the US Bankruptcy Code, contrasting them, where relevant, to the UK system of company administration. **(10 marks)**

20 Boards **18 mins**

In the context of company law, explain:

(a) Non-executive director **(2 marks)**
(b) Executive director **(2 marks)**
(c) Single board **(3 marks)**
(d) Supervisory board **(3 marks)**

(Total = 10 marks)

21 Criminal and civil law **18 mins**

(a) Explain the following with reference to the English court system:

 (i) Criminal law **(2 marks)**
 (ii) Civil law **(2 marks)**

(b) The Vienna Convention 1998 encourages adopting countries to criminalise money laundering. Describe the concept of money laundering and explain why it should be a criminal offence. **(6 marks)**

(Total = 10 marks)

22 Financial Services Authority **18 mins**

Explain the role of the Financial Services Authority as a regulator of company markets in the UK, paying particular attention to its role with regard to market abuse and money laundering. **(10 marks)**

1 Sources of law

Top tips. It may seem fairly obvious to you (we hope so, anyway) but the most important thing to bear in mind when answering this question is that you do answer the question on two legal systems, as required, no more, and no less. Even if you are an expert on all three systems covered in the syllabus, you can only gain marks for two in this question. And even if you have really only got to grips with one system, only answering according to one can only ever gain you half of the marks available for the question, and, in all honesty, probably not all of them. Even if you are uncertain about another system of law, try to put the basics down and glean a mark or two for that system. Lastly, you should note that the answer below discusses all three systems of law. This is for tutorial purposes only, and is not intended to be illustrative of how you should approach the question. You should only, as discussed above, have referred to two systems in your answer.

Sources of law

Sources of law will **vary** from **nation to nation**. For example, some countries, such as France, have national constitutions, while others, such as the UK, do not. Some countries are affiliated to a larger political enterprise, for example, the European Union, and others are completely autonomous. Some nations have dual systems of law for state and for small sections of that state, for example in the USA, there is a system of federal and state laws. However, in general terms, the **main sources of law within a particular legal ideology can be summarised**, and this has been done below.

(a) **Common law**

Common law is the name given to the system of law developed in England. It has since been exported to many states around the world. We shall therefore concentrate on the sources of law found in England, but make reference to additional sources found in other common law states.

The key sources of law in England are:

- Common law and equity (generally comprising case law)
- Statute law
- Custom (although this is of little modern significance)
- European Union law

Case law

Case law is **law made by judges** as a result of the operation of the **doctrine of judicial precedent**. This doctrine states that judges must follow principles of law in decided cases when deciding cases where the facts are materially the same, subject to certain conditions. Higher courts in the English system therefore create binding precedents, which become law for other judges to follow.

Case law therefore contains a great deal of the most **historic sources of law in England**, **common law** and **equity**. Common law was a body of law developed by the Normans in the centuries subsequent to their conquest of England in 1066. Equity was a complementary system developed by the king's chancellor's department, to provide alternative legal solutions where common law proved to be inflexible.

Statute law

Despite the historic importance of case law, statute is increasingly the more **important source of law** in the UK, particularly as a result of the need to implement legislation in accordance with European Directives (see **EU law** below). Statute law is **law made by Parliament**. Parliament may delegate its powers to make laws to other parties, whereupon legislation enacted is known as **delegated legislation**. Delegated legislation is subject to review by a Parliamentary committee, but otherwise it has the same status as statute.

European Union law

As the UK is a member of the European Union, it is an important source of law in the UK. The European Council and Commission can create law which is immediately binding on the UK in the form of **regulations**. They can also create law in the form of **directives**, which require member states to produce their own legislation to implement the provisions, as discussed above.

Other sources of common law

Another key source of common law in countries other than England (UK) is the national **constitution**. This does not apply to English law because, as mentioned above, the UK does not have a constitution. Other major common law countries, such as the US, have constitutions, which are a major source of law in those nations.

(b) **Civil law**

The key difference between civil law systems and common law systems is that civil law does not have a system of case law in the way that common law systems do.

Civil law systems, although they exist in countries with a **long legal heritage**, tend to have **laws** which were **enacted in written form at a specific point in time**. So, for example, French law, although rooted in historic Roman law, dates from the early seventeenth century when it was codified.

We shall use France as exemplar of a civil law system. The key sources of law in France are:

- The Constitution
- EU law
- Statute and administrative regulations
- Custom (of very limited modern purpose)

Constitution

As discussed above, where a country has a national constitution, this forms an important part of the nation's law.

EU law

Although France and UK have different legal ideologies, EU law impacts on them in the same way, so France has the EU as a significant source of law as does the UK, discussed above.

Statute and administrative regulations

Similarly, statute in France is very similar to statute in the UK. It is enacted law. In France, such law is often codified into comprehensive codes of legal areas. Administrative regulations are comparable to delegated legislation in the UK.

Custom

Custom (accepted historic legal rights) have very little role in modern France. However, if for any reason a judge is presented with a situation where there is a gap in enacted law, he must consult custom.

(c) **Sharia law**

The sources of law in sharia contrast strongly with the sources of law found in the civil and common law systems discussed above. This is because sharia is a law bound up in the **religion of Islam**. Whereas all law in the common and civil law systems is originated by man, Muslims believe that the Quran, the primary source of sharia, was sourced directly from God (Allah) to the Prophet Muhammad.

Sharia transcends national boundaries, although some nations, for example, Iran and Pakistan have adopted it in differing degrees on a national basis.

Sources of law in sharia:

- The Quran
- The Sunnah
- Major schools of law
- Any relevant national constitution

The Quran

The **Quran** is what Muslims believe to be Allah's divine word to his Prophet Muhammad. It is the holy book of Islam. It **contains a number of legal provisions**.

The Sunnah

The Sunnah is a body of **accepted legal principles** based on the sayings of the Prophet (known as ahadith). These were collated some time after the death of the Prophet and are classified according to their reliability. Some are virtually guaranteed to be sayings of the Prophet, and these are known as muwatir. Others, known as mashtur, are less certain. Where there is little certainty as to their authenticity, ahadith are called ahad.

Interpretation and schools of law

Although law is God-given and in one sense cannot therefore be interpreted by human beings, historically there have been several ways of **deducing the meaning of the law** and its **application** in sharia. These are known as **ijithad**. Subsequent to the death of the Prophet, several schools of law, used today as secondary sources of law in sharia, were developed according to these principles.

Ijithad is a collective term for a number of methods of 'interpreting' the law. The methods include the following:

- Ijma' (consensus of opinion of suitably qualified jurists or judges)
- Qiyas (analogical deduction: the application of a legal principle to similar facts)
- Istihsan (equity or fairness, within the boundaries of sharia law)
- Maslahah mursalah (similar to istihsan)
- 'Urf (local custom – where it is not contrary to the requirements of sharia)
- Istishab (a legal presumption that a state of affairs continues unless proven wrong)

The major schools of law developed by these methods are Shia, Hanbali, Maliki, Hanafi and Shafii. There is **controversy** in the Muslim world about **whether ijithad should still be exercised**. Strongly orthodox Muslims adhere to the theory of **taqlid**, which states that no further interpretation should be carried out.

2 Court adjudication or alternative dispute resolution

Top tips. This question requires to you compare and contrast. You have therefore consider all the factors (advantages and disadvantages of each system) and determine whether you are going to structure your answer according to these factors (for example, cost, speed, privacy) or whether you are going to discuss the advantages and disadvantages of one system, then the other, then conclude. An answer plan, or an initial brainstorm will significantly help you in this process and will go towards making sure that your answer is not an unstructured mass of points. Ensure that you draw a conclusion at the end. The answer to this question is slightly complicated as the benefits and disadvantages of each will vary according to which nation the person with a legal dispute is in. You may want to answer from the point of view of a national legal system you are familiar with, and add comments about other nations where you are aware of specific factors. However, given that this is a global paper and the question does not specify that you should attach your answer to a national system, it is probably better to take a general approach, ours is based on the UK system and we have used an example in this text.

Cost

Cost is clearly an issue to persons seeking legal recourse.

The cost of taking a legal dispute to court will vary depending on the nature and size of the dispute and the country in which the court is situated. In general terms however, the **court building and its personnel** are probably **available without direct charge** in most countries, which is not true of ADR, see below. As discussed below, legal representation may be required, which can substantially add to the cost, particularly in countries such as US and UK where there are systems of pre-trial disclosure.

In most cases, if a matter is resolved **outside the courts**, for example by mediation, conciliation or arbitration, the **parties have to bear incidental costs of the process**, for example, for the venue and for the arbitrator or mediator. However, there may be a saving on the cost of legal representation and the speed of ADR also limits the extent of such costs.

Speed

Speed can be another very important issue for someone seeking legal recourse. The dispute might be causing business interruption or unlawful action need stopping as soon as possible.

A serious disadvantage of the **court system** is that it **can take a large amount of time for legal cases to be brought before judges**. If cases need to be appealed, this adds to the time. Some legal cases take years, rather than months. The problem is probably greatest in common law countries, where the practice of pre-trial disclosure adds to the length of time it takes to get a resolution in court proceedings.

In contrast, a significant advantage of **alternative dispute resolution** is that proceedings can be much quicker, with **less** of the **formality** required of court proceedings. The proceedings are more **flexible**, with the parties determining factors such as venue and involved parties, which means that proceedings can be carried out very quickly.

Privacy

Most nations have **open courthouses** meaning that **legal cases** taken to court are **potentially public affairs**. This will not be important to many persons seeking legal recourse, but some cases involve high profile parties or deal with sensitive commercial matters, and if they are tried in court, the media may take an interest in proceedings.

Comparably, another great advantage of **ADR** is that regardless of the type of procedure being carried out (arbitration or mediation, for example), it is usually carried out behind **closed doors**, so that the matter is kept **private**.

In some cases, the publicity of court cases may be important to the parties, if bad publicity has been received about a matter and a party wants to be publicly exonerated from something. In such cases, the public nature of a court forum might be an advantage to a party.

Adjudicator

Although judges are experts in the law, they are not necessarily experts in the context of the legal dispute, for example, business or shipping, say. When a judge needs to obtain understanding of non-legal matters which are integral to the legal proceedings, it will be necessary for the parties to make use of **expert witnesses** at a cost to the parties. This not only adds to cost, but to time taken in court and in waiting for all relevant parties to be available.

In arbitral proceedings, the parties are entitled to **choose the arbitrators** of their case. This means that they can ensure the people hearing the dispute are expert in the particulars of a case, which they may feel will benefit the outcome of the case and in most circumstances will increase the speed of the case. The downside is that particular experts may be expensive to hire. In addition, arbitrators will sometimes also use the work of an independent expert, so this time and cost may not be eliminated by choosing ADR.

Venue

We have already mentioned how in ADR, the parties may choose the venue for their dispute. This may result in greater convenience for them than if they were taking a case to court, whereupon the venue would be dictated to them and might not necessarily be local to them (often dependent on the size of the case).

Legal representation

As has also been referred to above, in some countries it is necessary or preferable to employ legal advisers and counsel when going to court, which can significantly add to cost. This may or may not be the case when seeking alternative procedures, but it is at least likely to be more a matter of preference.

Nature of outcome

Whether parties seek resolution in the courts or under alternative procedures may often depend on the **outcome** they are seeking. Alternative dispute procedures may also result in **alternative 'remedies'** to those obtained in court, for example, an apology, a compromise or a promise that one party will do something differently in the future. Decisions reached as a result of arbitration may be **binding** in the same way as court decisions, but some other dispute resolution methods rely on the parties keeping their promises, which some parties may feel is not **sufficient assurance** for them.

Conclusion

Both court based resolution and alternative methods have advantages and disadvantages as discussed above. What method of dispute resolution a party chooses will depend on many factors, not least the **particulars of the court system** in their own country, but also matters such as **time pressure**, **complexity** of the case and the **need or not for privacy**.

3 Arbitration agreements

Top tips. Arbitration is likely to be a frequently examined subject as it is an attractive form of dispute resolution compared with international court proceedings. Make sure that you can define both arbitration and an arbitration agreement, and are clear about the rules on the form of the latter.

(a) **Arbitration agreement**

Under the Model Law, an arbitration agreement is an agreement between the parties to an international, commercial contract to **submit to arbitration** all or certain disputes which have arisen or which may arise between them in respect of a **defined legal relationship**, whether contractual or not. It may either be an arbitration clause in another contract, or a separate agreement.

The arbitration agreement must be in **writing**, which means that it must be in a **document signed by the parties** or in an exchange of letters or other forms of written (tele)communication which provides a **record of the agreement**. Alternatively it can be in the form of an exchange of statements of claim and defence in which it is stated by one party and not denied by the other. Finally an arbitration agreement may be evidenced in another document to which a written contract between the parties refers.

An agreement is international if it relates to **one or more parties who have their places of business in more than one state**, or the agreement covers more than one state, or the place of performance of the contract is in more than one state. If one or more of the parties have more than one place of business, the relevant place of business for the purpose of an arbitration agreement is the place with the closest relation with the arbitration agreement.

(b) **Writing**

Any arbitration agreement under the Model Law must be **in writing**. Such an agreement is effective to ensure that, if an action is bought before a court in relation to a matter for which the arbitration agreement exists, the court will not hear it but rather will refer the matter to arbitration. Even if the arbitration agreement itself is subject to court proceedings, the arbitration proceedings related to it can still be initiated.

4 Application of the Convention

Top tips. This is a very straightforward question provided you are fully aware of the rules set out in Chapter 4. It is conceivable that elements of this topic could also be included in a scenario, so you must make sure that you have covered it well.

(a) **Article 1**

Article 1 of the Convention states that it applies to **contracts for the sale of goods between parties whose places of business are in different states**. There are two situations identified in the Article. The simplest case is that both parties' states are 'contracting states' (ie are covered by the Convention). The other case is that one party can be in a non-contracting state, but the parties have agreed that the private law of the contracting state shall apply. In this case, the Convention is applied via the private law of the contracting state.

For the purpose of Article 1, **place of business** is important, not nationality. If a party has places of business in more than one state then the place of business that is most closely connected to the contract will be taken to be its place of business when applying Article 1.

(b) **Application**

The Convention applies to the **sale of goods**, which can include the supply of goods to be manufactured and produced unless the party who ordered the goods undertook to supply a substantial part of the materials necessary for such manufacture or production (Article 3). It does not apply to contracts where the major obligation of the seller consists of the supply of labour or other services.

Specifically, under Article 2 the Convention does not apply to sales of goods bought for **personal**, **household** or **family use** unless the seller did not know that this was the purpose for which they were ordered by the buyer. It also does not cover sales by auction or by operation of law. Sales of certain types of 'goods' are also excluded: stocks, shares, investment securities, negotiable instruments, money, ships, vessels, hovercraft, aircraft or electricity.

5 Incoterms

Top tips. You should familiarise yourself with these key incoterms, so that you can provide swift explanations if a question like this should arise.

(a) **FOB**

FOB stands for **free on board**.

The term FOB is usually followed by the name of the **port of departure** of the goods. A fob contract is one where the buyer makes arrangements for shipping and the seller discharges his duty by putting the goods on board. This is the default position in the UN Convention.

In such a contract, the seller does not have obligations in respect of **carriage or insurance** of the goods after he has placed them on the vessel. However, he is required to provide any export license or other authorisation required at his own expense, bear the risk and expense of the goods until they are on the vessel.

Consequently the buyer must bear responsibility for **risk** of the goods from when they are on the vessel and obtain any import licenses required.

(b) **CIF**

CIF stands for **Cost, Insurance, Freight**.

Under a CIF contract, the seller is required to bear the **cost of insurance and freight** (carriage) for the goods.

Per the incoterms, the seller must **contract for carriage** on the usual terms for the goods to the named port of destination by the usual route and in the way normally used for such goods.

In terms of **insurance**, he must obtain insurance for the goods that enables the buyer to claim directly from the insurers in the event of loss. This should be with an insurance company of good repute. The minimum insurance cover should be that which is stated in the contract plus 10%.

(c) **EXW**

EXW stands for **Ex Works**.

Under such a contract, the seller has minimum obligations with respect to **delivery**. He simply has to make the goods available to the buyer at his **own place of business** (works). Ex means 'from' in Latin.

(d) **CPT**

CPT stands for **Carriage paid to**.

This is where the seller pays for **carriage to a named location**. The **risk** for the goods passes from seller to buyer when the goods are passed to the carrier.

6 Quality in sales of goods

Top tips. This question requires application of the law to a given scenario. Make sure in such questions that you do not repeat yourself.

UNCISG

Under Article 35 of the UN Convention on the international sale of goods, the seller must deliver goods to the buyer that are of the **quality required by the contract**.

If the contract is silent on quality, the goods must meet the conformity requirements as follows:

- they must be **fit for the purpose** for which goods of the same description would ordinarily be used
- they must also be **fit for any particular purpose** made known to the seller
- they must possess the **qualities of any sample or model** used during the process of forming the contract

A's and B's contract is silent on quality, so the rollers should meet the conformity requirements set out in (a) above. The rollers should be fit for their usual purpose, which is rolling. The contract also mentions their use in mangling, so they should also have been fit for that particular purpose. They are not fit for mangling, but they are fit for rolling.

The point at issue is that while the goods are fit for rolling, they are not fit for mangling.

As A delivered the rollers three weeks early, B had plenty of time to **examine the rollers** as soon as possible after their delivery by A, as he had a duty to do. If he had done so, he would have identified the non-conformity and A could have corrected it. The loss in transferring the rollers to rolling from the failed mangling process would thus have been avoided.

As B did not examine the goods at all before putting them into the mangling process, he entirely loses the right to rely on a lack of conformity of the goods. This is because first he **did not inspect promptly**, and secondly he **did not inform A** within a reasonable time of discovering the non-conformity (he delayed until May 20X4): *UN Case 48*.

Breach of contract

Breach of contract is where one party fails to perform his obligations under the contract. B is not suing A for fundamental breach of contract, so he is saying that there was not such detriment to B as to substantially deprive him of what he was entitled to expect under the contract. In addition, B is seeking damages rather than to exercise his specific rights under the Convention to require performance (Article 48), to declare the contract avoided (Article 49), or to reduce the price in relation to the non-conformity (Article 50). Damages in this case would represent a **monetary sum that is equal to the loss, including loss of profit**, suffered by B as a consequence of A's non-fundamental breach.

B wants damages for losing 30% of the rollers when transferring them to rolling from the failed mangling process. He is also seeking loss of profit on the mangled rollers.

As B did not inspect the goods, prevented A from being able to rectify them and delayed in informing A of the loss, it would appear that his case is fairly weak. We are not told whether B mitigated his loss, by seeking replacement rollers for the mangling process so that the profit was not lost: *Payzu Ltd v Saunders*.

To sum up: A is in theory liable for the non-conformity of the rollers for the mangling process, but B's actions weaken his case. If they are awarded at all, damages will be reduced.

7 Payment

Top tips. This question has three parts and also three parts of the requirement, so in order to score well on this question, you basically have to make one relevant point for each of these things. The three parts of the requirements are compare, contrast, explain. Make sure that you try and comply with all these requirements in all the parts of the question.

(a) **Bank transfers**

These are payments made directly and electronically through the bank. They therefore do not rely on systems outside of the bank, such as the postal system. They may also be arranged over the telephone, subject to authentication procedures.

Advantages

They are easy to organise and the most direct and quick way of making payments to overseas suppliers.

(b) **Bills of exchange**

These involve written promises to pay a named person a sum of money. They will rely on postal systems, as the bill must be sent to the recipient, who may then cash it at a bank.

Advantages

As the bill of exchange requires the signature of the buyer, they may be less subject to fraud than bank transfers. For example, a person would not have to arrange a transfer in person, and if they had access to the relevant codes and procedures, might be able to convince the bank that they had authority to make a transfer.

(c) **Letters of credit**

These are an arrangement set up through the bank whereby the seller can obtain immediate finance for a contract although the bank extends the buyer a period of credit. These are complex to arrange in comparison to bills of exchange and bank transfers.

Advantages

However, the advantage of these is the certainty that they give the seller about obtaining his money for the goods. They are vital where a customer is high risk, or previously unknown to the business.

8 Model law on agency

Top tips. This question requires you to set out a particular aspect of law if you state the basic rules in the model law, re lack of agreement on law between both principal and agent and third parties, then you should score well. Explain any exceptions.

UN model law on agency

The model law sets out the position **when parties do not agree the law that is going to govern their agency relationship**. This falls into two categories:

- Relationship between the principal and agent
- Relationship between the agent and third parties

Principal and agent

The relationship between the principal and agent includes the **formation** and the **validity** of the **legal relationship between them**, their obligations under the agreement, conditions attached to how the agent should perform his duties, the consequences if their agreement is breached, and when the arrangement comes to an end.

Basic rule

The basic rule is that the relevant law is the **law of the state** where the **agent** had his **place of business** at the **formation** of the agency relationship.

Place of business

If the parties do not have places of business, reference in the model law to place of business should be read as 'habitual residence'. If the parties have more than one place of business, the relevant place of business will be the one most closely connected with the business for which the agency relationship is being formed.

Exception to the basic rule

Although usually the relevant law will the law of the agent's place of business, if the **agent** is to **perform** his **function** in the place **where** the **principal** has his **place of business**, the relevant law will be the **law of that state**.

So, for example, if Alison, who has a place of business in England, is to be Ben's agent, and she is to perform her duties in France, where Ben has his place of business, French law would govern their relationship. If she was to perform her duties in Germany, English law would govern their relationship by virtue of the general rule given above.

Agent and third parties

Regardless of what law governs the relationship between the principal and the agent, in terms of the agent performing his duties and interacting with third parties to the agency relationship, different law may apply.

The **law of the state in which the agent is acting** will **always be taken into account**. In addition, in the absence of express agreement over which law will otherwise be relevant, the model law gives another basic rule to which there are a number of exceptions.

Basic rule

The agent's authority and its effect on third parties will be governed by the law of the state in which the **agent** had his **place of business** at the **time of the acts**.

Using the example of Alison and Ben, above, and introducing a third party, Caitlin, with whom Alison is contracting on behalf of Ben, if Alison were carrying out her duties in Germany, her relationship with Ben would be governed by English law and her relationship with Caitlin by English law also, although German law would be taken into account.

Exceptions to the basic rule

Under the **exceptions** to the basic rule, the relevant law will be the **law of the state in which the agent** has acted in the following circumstances:

- If the agent has **acted in the name of the principal** in the country **where** the **principal has his place of business**
- If the agent has acted in **any country where the principal** has his **place of business**
- If the agent has acted at **exchange** or **auction**
- If the **agent** has **no place of business** of his own

So, using the same example of Alison, if she is contracting with Caitlin on Ben's behalf in France, French law will govern all her relationships.

Non face-to-face transactions

A final complication is this: if Alison is in Germany negotiating with Caitlin, but they do not meet, the model law deems that this is the same as if Alison had been negotiating from Alison's place of business, and hence English law will govern their relationship.

9 Authority and limited partnerships

Top tips. This is a straightforward factual question and is nicely broken down so that you should be able to gain good marks on each part. Notice that part (b) is asking specifically about limited liability partnerships, so you should restrict your answer to consideration of those.

(a) **Apparent authority**

Partners in a firm are regarded as having both **actual** and **apparent authority** to bind the firm. Their actual authority is the authority given to them by the partnership agreement to carry out certain acts.

Their apparent authority is defined by the **Partnership Act 1890**. This states that every partner is an agent of the firm and the other partners for the purpose of the business of the partnership. The partner's actions in the normal course of business, of a sort that the firm would normally be expected to do, bind the firm and the other partners, so that they too are liable to the third party. However, if the partner does not have the authority to make the contract, and the **third party knows that to be the case or does not know or believe him to be a partner**, then the firm will not be bound.

For example, X is a partner in a firm that runs a garage buying and selling second hand cars, but the partnership agreement states that the firm is not to trade in new cars. If X enters a contract for the purchase of a new car from a third party who is not aware of the prohibition in the partnership agreement, then the firm as a whole would be bound by that contract, as X had apparent authority to enter into it.

The purpose of the law is the **protection of third parties**, and the nature of the authority often depends on the perception of the third party involved. If the third party genuinely believes that the partner has authority, the firm is likely to be bound by the partner's actions.

(b) **Limited liability partnership**

A **limited liability partnership (LLP)** formed under the Limited Liability Partnership Act 2000 is a corporate body with separate legal personality from its members, but it retains some of the features of a partnership.

In order to be incorporated, the subscribers must file details with the Registrar of Companies:

- The name of the LLP
- The location of its registered office (ie England and Wales, Wales or Scotland)
- The address of the registered office
- The names and addresses of all the members of the LLP
- Which members are to be designated members, who take responsibility for the publicity requirements of the LLP.

The designated members of a LLP are required to:

- File notices with the Registrar of Companies, for example when a member leaves
- Sign and file accounts
- Appoint auditors if appropriate

10 Companies

Top tips. This question is extremely straightforward, and if you are well-prepared, you should be able to score very well on it indeed. Remember to attempt each part of the question to give yourself every opportunity of scoring highly.

(a) **Public limited company**

A public limited company is a company (an entity so registered under the Companies Act) that states in its constitution that it is a public company and has complied with the registration procedures for such a company.

Special registration procedures

As well as stating in the constitution submitted to the Companies Registrar that the company is public, a company registering as a public limited company must obtain a special trading certificate to allow it to trade.

Distinguished from a private company

A company which does not meet the criteria to be a public company is by default a private company. The key difference between them is that public companies are entitled to offer their shares to the public. Public companies can (although they do not have to be) therefore be listed on stock exchanges, whereas private companies may not.

(b) **A parent company**

A parent company is a company which **controls** another company (the subsidiary) by virtue of one of:

- Holding a majority of voting rights in the other company
- Being a member of the other company able to appoint/remove directors
- Holding the right to exercise a dominant influence over the other company
- Controlling the voting rights in the other company
- Being a parent company of a company that fulfils one of the above

The parent company and the subsidiary company form a simple **group of companies**. Groups of companies can be much larger that two companies, as a company may control a large number of other companies (each of which is therefore a subsidiary) and subsidiary companies may also be parent companies. As can be seen in the last bullet point above, when a subsidiary company is also a parent company, its parent company is also a parent company of the subsidiary's subsidiary. This is illustrated in the following diagram.

P1 – Parent (of S1, and by virtue of S1's relationship with S2, of S2)

↓

S1 – Subsidiary (which is also a parent of S2)

↓

S2 – Subsidiary

(c) **Multinational company**

A multinational company is one which produces and markets its products in more than one country. Such companies may also be listed on several different national stock exchanges, although it is not the multiple listing which renders a company multinational, but its actual operations.

The vast majority of companies in the world simply operate in one country, even if their products may be exported, but some huge multinational companies such as Microsoft or Coca Cola operate in many different countries and are genuinely global.

11 Incorporation and promoters

Top tips. The question is very specific about the information required for each part. You should follow a similar approach if you are asked to write generally about pre-incorporation contracts. Remember that pre-incorporation contracts cannot be ratified when a company is incorporated; evidence of a new contract is required.

(a) (i) **Definition**

A company is usually formed by a **promoter**, who is 'one who undertakes to form a company with reference to a given project and to set it going and who takes the necessary steps to accomplish that purpose'. It is a promoter who enters into pre-incorporation contracts.

Pre-incorporation expenses

A promoter cannot enter into a contract to be paid for expenses incurred before incorporation, such as drafting legal documents, because the company does not possess legal capacity prior to being incorporated. However, he can generally arrange that the first directors, of whom he may be one, should reimburse him or pay the bills.

(ii) **Definition**

A **pre-incorporation contract** is a contract made in a company's name before it is formed. Companies are not bound by such contracts as they do not exist when the contracts are made.

Company cannot ratify

It follows that a company can never ratify a pre-incorporation contract made on its behalf. Since it did not exist when the pre-incorporation contract was made, it cannot be made a party to it.

Need for novation

Once the company is incorporated there must be **novation** for a pre-incorporation contract to be enforced. This means that a new contract is made with the same subject matter, or the terms of the contract modified to the extent that it constitutes a new offer.

(b) **Liability of promoter**

Although a company is not liable on a pre-incorporation contract the promoter may nevertheless incur personal liability in statute.

S 51(1)

S 51(1) of the Companies Act contains the statutory provisions relating to pre-incorporation contracts. It states that where a person contracts in the name of, or as agent for, a company before its incorporation, that person will be personally liable unless there is agreement to the contrary.

12 National Hair Brushes

> **Top tips.** A common error when answering questions like (b) about confusion of names is solely to discuss passing-off. Don't forget there are statutory remedies available as well.

MEMORANDUM

To: Board of Directors, National Hair Brushes plc
From: Adviser
Date: 30 June 20X7
Subject: Formation matters

(a) In order to carry on its business under the name 'Wave Oh', National Hair Brushes plc must comply with certain requirements as follows.

(i) It must **state** its **registered name, number** and **address** legibly on all business letters (including emails), invoices, receipts, written orders for goods and services and written demands for payment of debts.

(ii) It must **display** its **registered name** and address in a prominent position in any **business premises** to which its customers or suppliers have access.

(iii) It must **give notice** of its **registered name** and address to **anyone who does business** with the company and who requests that information.

(iv) The **address** must be one at which **service of a document** relating to the business will be **legally effective** and must be within Great Britain.

(b) **Passing-off action**

Lancashire Hair Brushes plc may seek to bring a **'passing-off action'**, a common law action which applies when one company believes that another's conduct (here the use of a company name) is causing **confusion** in the minds of the public over the goods which each company sells. Lancashire Hair Brushes plc would apply to the court for an injunction to prevent National Hair Brushes plc from using its name.

However, in order to be successful, Lancashire Hair Brushes plc will need to satisfy the court, that:

(i) **Confusion** has arisen because of National Hair Brushes use of its registered name.

(ii) It lays claim to **something exclusive** and distinctive and not something in general use. The courts are unlikely to rule that the name is exclusive and distinctive here.

Appeal to the Company Names Adjudicator

Alternatively Lancashire Hair Brushes plc might object to the Company Names Adjudicator that the name National Hair Brushes is too like its own name and is causing confusion, thus appealing for him to exercise his power under the Companies Act to compel a change of name. In these circumstances, the adjudicator would review the case and decide whether or not the name should be changed, if so the adjudicator may decide upon the name. If the case goes against National Hair Brushes, it can appeal to the court which may reverse the adjudicator's decision or affirm it. The court has the power to determine a new name.

13 Articles

Top tips. It is essential that you have a good understanding of the articles of association, since reference to them is needed when considering many aspects of company law. Ensure you can explain how the articles constitute a binding contract, and do not confuse the articles with the memorandum.

Content of articles

A company's articles of association form the basis of its constitution along with its resolutions and agreements. It lays down rules governing its **internal management** and the rights of its shareholders and directors.

The principal areas covered will be the issue and transfer of shares, members' rights and the conduct of general meetings, the appointment, dismissal, powers, responsibilities and liabilities of company directors, dividends, class meetings, communication with members and documents and records.

Where a company does submit its own articles on incorporation, these must be **signed** by the **subscribers** to the memorandum of association. Companies which do not submit articles on registration will be allocated default, or model, articles relevant to the type of company registered.

Legal effect of articles

S 33 states that the constitution of a company (and therefore its articles) **bind the company and its members** to the same extent as if they had been signed and sealed by each member and each member had covenanted to observe all their provisions. Thus the articles are treated as a binding contract between the company and its members and as a binding contract between the shareholders.

Thus the company's articles were enforceable by the company against one of its shareholders in *Hickman v Kent or Romney Marsh Sheepbreeders Association 1915*. The rule applies only where the shareholders' rights affected are their rights as members and not in any personal capacity or capacity as director: *Eley v Positive Government Security Life Assurance Co 1876.*

The case of *Rayfield v Hands 1958* illustrates the existence of a contract between company members under s 33. In this case the articles required that the directors should purchase the shares of any member wishing to transfer his shares and also that the directors should also be shareholders. When the directors claimed that their liability was not as members and that the article was not enforceable by members, it was held that the article created an enforceable contract between the claimant members and directors as members of the company.

The articles do **not constitute a contract with any third party** by virtue of s 33: *Eley v Positive Government Security Life Assurance Co 1876*. However, where a contract between a company and a third party fails to address an issue which is covered in the company's articles, the relevant provisions may be taken to supply a missing contract term: *Re New British Iron Co, ex p Beckwith 1898*.

If legislation enables a company to do something provided its articles contain appropriate authority, the company, in the absence of such authority, will need to **alter** its **articles** first of all before doing the thing permitted. The alteration must be *bona fide* for the benefit of the company as a whole, meaning the individual hypothetical member. Alterations cannot be made if their effect is to place the articles in conflict with the general law or statute. The courts will look with suspicion upon changes that give some members the power to expel others (*Dafen Tinplate Co Ltd v Llanelly Steel Co (1907) Ltd*), unless the benefit to the company is clear (for example expulsion of a member who is competing with the company: *Sidebottom v Kershaw Leese & Co Ltd 1920*). The fact that a contract with a third party may be broken by a change in the articles does not invalidate that change, however damages may be payable: *Southern Foundries v Shirlaw 1942*.

In some cases, provisions of a statute may prohibit a company from doing something notwithstanding anything to the contrary in its articles of association.

A company may alter any of its articles (usually) by the passing of a **special resolution** to that effect. However s 22 permits companies to 'entrench' provisions into their articles. This means specific provisions may only be removed or amended if certain conditions (which are more restrictive than a special resolution) are met.

14 Shares

Top tips. This is a straightforward question, but ensure you think about your answer carefully to avoid missing out points and dropping valuable marks.

(a) **Share capital**

A share is 'the **interest of a shareholder in the company measured by a sum of money**, for the purpose of a liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders *inter se'.*

A share must be **paid for** and it gives a proportionate entitlement to **dividends**, **votes** and any **return of capital**. It also constitutes a form of bargain **between the shareholders**, underlying such principles as majority control and minority protection.

A share is a form of **personal property** carrying rights and obligations, which is **transferable** in accordance with the company's articles on transferability of shares. Shares in a public company are freely transferable provided the appropriate procedures are followed.

The **nominal value** of the share usually fixes the amount of the shareholder's liability, ie how much he can be required to contribute to the company's assets. The shareholder's right to share in the company is the right to receive a **dividend** in the company's profits and not a share of the company's **capital assets**.

(b) **Types of share capital**

(i) **Issued share capital**

This is the nominal value of all shares which have been **allotted to members and issued as share certificates**. Where part of its share capital has not been issued, this part is called the unissued share capital. A public company must have at least £50,000 issued share capital.

The issued share capital is the measure of the substance of a company.

(ii) **Paid up share capital**

This is the proportion of the nominal value of the issued capital actually **paid**. An allottee of shares must pay the **nominal value** of those shares plus any **premium due** on them.

Once the amount due has been paid, the shares are **'fully paid'**. However, it is possible for part of the payment (or all of the payment in the case of private companies only and very rarely) to be **deferred** to a future date (either fixed or on demand from the directors for example) or to be payable in **instalments**. In such cases the shares are referred to as **'partly paid'**. In the event of the shares being transferred, the unpaid capital passes with the shares as a debt payable by the holder at the time when payment becomes due.

In the case of public companies, at the time of allotment the company must receive payment for at least **one quarter of the nominal value of the shares and the whole of any premium**. Thus partly paid shares of a public company (except those issued under an employees' share scheme) must always be at least one quarter paid up.

15 Debentures and charges

Top tips. This question, like the last is very straightforward. Commit the terms to memory.

(a) **Debentures**

There is no statutory definition of 'debenture' (though s 738 Companies Act 2006 states that a debenture includes debenture stock, bonds and any other securities of a company, whether or not constituting a charge on the assets of the company).

In essence, a **debenture** is a document which states the terms on which a company has borrowed money (creating or acknowledging the debt).

A debenture is often **secured** (by also creating a fixed or floating charge over some or all of the company's assets) but may be unsecured, in which case it is likely to be called an unsecured loan note to distinguish it from a secured debenture.

A debenture usually takes the form of a printed legal document, setting out the **terms** of the loan and providing for the payment of **interest** to the debenture holder (regardless of profits). It might be a single debenture or one of a series ranking **pari passu** (for example, where the directors or members provide different loan amounts at different times but all loans are intended to rank equally). It might be one which governs the issue of debenture stock subscribed to by a large number of lenders (typically the public at large).

(b) **Fixed charges**

A **fixed charge** attaches to a specific asset as soon as the charge is created. If the company fails to honour its commitment to pay interest or repay the amount borrowed or goes into liquidation, the asset will be passed to the chargeholder, or sold to realise the debt, and the proceeds of the sale will go to the fixed chargeholder in preference to preferential creditors and floating charges. The company cannot dispose of the asset without the consent of the chargeholder.

The fact that a document is called a fixed charge will not be conclusive where in fact the company is still permitted to deal with the charge without reference to the chargee: *R in Right of British Columbia v Federal Business Development Bank 1988.*

Examples of fixed charges are legal mortgages of shares or land, or charges over other property.

(c) **Floating charges**

A **floating charge** is:

(i) A charge on a **class of assets** of a company, present and future

(ii) Which class is in the ordinary course of the company's business **changing** from time to time, and

(iii) Until the holders enforce the charge the company may **carry on business** and **deal** with the asset charged: *Re Yorkshire Woolcombers Association Ltd 1903*.

A floating charge can apply to fixed assets and current assets. It does not attach to any assets until crystallisation (when it becomes a fixed charge).

16 Issuing shares

Top tips. You need to spend a similar amount of time on both parts of this question as they are for similar marks. Remember the golden rule when it comes to issuing shares (never at a discount to nominal value) and state it clearly.

(a) **Share premium**

A company may issue shares for a price **in excess of the nominal value** of those shares. The excess is called the **'share premium'** and must be credited to a share premium account.

It is not necessary for the articles of association to include a **power** to issue shares at a premium since it is **implied**. Where the shares are issued for a non-cash consideration in excess of the shares' nominal value, the excess should still be credited to the share premium account, since the statutory rule applies to issues of shares 'at a premium whether for cash or otherwise'.

The general rule is that reduction of the share premium account is subject to the same restrictions as reduction of share capital.

- **No part** of the account can be distributed as **dividend**.
- The account can be used to pay up fully paid shares under **a bonus issue** since this operation simply converts one form of fixed capital into another.
- It can also be used to pay **issue expenses** and **commission** in respect of a **new share issue**.

The share premium account is included in the **'undistributable reserves'** when determining whether a **dividend** can lawfully be declared by a public company (which can only make a distribution if its net assets are not less than the aggregate of its called up share capital and undistributable reserves).

(b) **Issuing shares at a discount**

Every share has a nominal value and cannot be allotted at a discount to that value. A company must obtain in money or money's worth consideration of a value at least equal to the nominal value of the shares allotted plus the whole of any premium. If shares are allotted at a discount, the allottee (and subsequent ones) is liable to pay the full nominal value together with interest at the appropriate rate.

The issue of shares at a price which is less than the market value (but equal to or more than the nominal value) of existing shares does not contravene the provision.

In the case of **private companies only**, shares may be allotted for inadequate consideration by the acceptance of **goods or services** at an over-value. A blatant and unjustified overvaluation will not, however, be upheld. **Non-cash consideration must be independently valued in the case of public companies**.

17 Statutory duties

Top tips. Limit your answer to a sentence or two on each duty as you need to explain five duties.

The Company's Act 2006 introduced seven statutory duties that directors must meet.

(i) **Duty to act within powers (s 171)**

This duty requires directors not to exceed the powers given to them by the company. In particular they must only exercise powers for the purpose for which they were conferred.

(ii) **Duty to promote the success of the company (s 172)**

The principle of 'enlightened shareholder value' requires directors to act in a way which is most likely to promote the success of the company for the benefit of the members as a whole.

(iii) **Duty to exercise independent judgement (s 173)**

Directors must exercise independent judgement. They must not delegate their powers or be swayed by the influence of others.

(iv) **Duty to exercise reasonable skill, care and diligence (s 174)**

Directors have a duty to exercise the same standard of care, skill and diligence that would reasonably be expected of a reasonably diligent person with;

– The general knowledge, skill and experience which may be reasonably expected of a person in their position and

– The general knowledge, skill and experience they actually have.

(v) **Duty to avoid conflicts of interest (s 175)**

The Act suggests a number of circumstances where a director's personal interests may conflict with the company's interests. Directors have a duty to avoid such circumstances.

(vi) **Duty not to accept benefits from third parties (s 176)**

This duty prevents directors from accepting benefits from parties outside the company (usually bribes). It supports the duty under s 175 by preventing a potential conflict of interest.

(vii) **Duty to declare an interest in proposed transaction or arrangement (s 177)**

Directors must declare the nature and extent of any proposed arrangement or transaction they may be involved in with the company either personally or through a third party. Disclosure may be given by written or general notice or a board meeting, but must be made to the directors, as disclosure to the members is not sufficient to discharge the duty.

Note only an explanation of five of the duties was required in the question.

18 Hydrangea

Top tips. The marks in this question would have been weighted towards giving details of what the **notice** of the meeting should contain; as the directors are unsure about the requirements, it is quite possible that the notice would not contain sufficient details if you just told them that they had to give notice.

To pass (a), you would also have had to identify correctly the **types of resolution** required; special for a change of name, ordinary for routine business.

In (b) your answer should have stated that votes are normally taken on a show of hands. Because holding a poll depends on certain conditions being fulfilled, you needed to describe what these conditions were.

(a) **Calling of the meeting**

All the business can be handled by an AGM so no other general meeting is required.

Notice of the meeting

Notice of the AGM must be sent to every **member** of the company who is entitled to attend and vote at the meeting. It should also be sent to the directors and auditors. The notice should:

(1) Give adequate information concerning the **date, time and place** of the meeting

(2) Specify it is an **AGM**

(3) Describe the proposed **special resolution** as such

(4) Give sufficient **details** of the **proposed business** at the meeting to enable recipients of the notice to understand what it is proposed to be done at the meeting

Length of notice

The length of notice required for AGMs is 21 clear days notice.

Approving the accounts and re-electing directors

These resolutions are deemed ordinary business and should be passed by an ordinary resolution of the company, which is carried by a simple majority (over 50%) of votes cast.

Changing the company's name

Authority to change the name of a company requires a special resolution of the company, which means a 75% majority of votes cast is needed to pass it.

(b) **Voting rights of members**

The **rights** of members **to vote** and the **number of votes** to which they are entitled will be **determined by** the company's **articles**.

Show of hands

Voting is normally done by a **show of hands** by each member present in person. Each has **one vote**.

The chairman's declaration of the result on a show of hands (in the absence of it being fraudulent or manifestly wrong) will be conclusive. **Voting** by **show of hands** will **not be effective**, however, where a poll is properly demanded.

Polls

There is a statutory right to a poll wherever a special resolution is proposed. Voting on a poll may be demanded by at least **five members** or by **members representing at least one tenth of the voting rights** or by members holding **at least one tenth of the paid-up capital** conferring voting rights. (A company's articles cannot make these criteria more onerous from the shareholders' point of view.)

Where voting is on a poll, every member present may cast the **full number** of votes to which they are entitled. This is normally one per share held.

Voting rights of proxies

Every member entitled to **attend** and **vote** at a meeting may instead appoint at least one proxy to attend and vote for him. The proxy need not be a member.

Notice of the meeting must contain a statement which explains each member's **right to appoint** a non-member proxy. **Proxies may vote on a poll** since they have the same right to demand a poll as the member whom they represent. Most companies issue **two-way proxy cards** on which the member instructs his proxy to vote either for or against each resolution.

19 Company rescue

Top tips. This is a straightforward 'explain' question. Do not forget to draw the relevant contrasts to UK insolvency law to gain the top marks.

Chapter 11

Chapter 11 is the corporate reconstruction section of the **US Bankruptcy Code**. It sets out a procedures whereby the company is given a **moratorium period** to put together a plan of reorganisation for the company to be able to pay debts.

Moratorium

The **court** must approve an application for such a procedure, after which the company is given temporary relief from debts dating from before the application and only has to pay certain debts after the application.

The debts that it must pay after the application are **wages**, **expenses**, **taxes** and **administrative expenses**.

This is similar to the procedure in the UK whereby once an administrator is appointed, administration commences and no creditor can enforce a debt against the company without permission from the court.

Who may apply?

The US Code allows for **voluntary or involuntary application**. A voluntary application is one made by the company. An involuntary application may be made by at least three unsecured creditors whose claims exceed a statutory amount.

In the UK, the company or creditors may apply for administration, but a **secured floating chargeholder** has a stronger position than the company as he may effectively veto the company's choice of administrator. In addition, the in the UK, an application may be made by a single floating chargeholder, rather than the three creditors in the US system.

Plan of reorganisation

After the court has approved the application, the company has 120 days to file a **plan of reorganisation**. If the company does not do so, or certain interested parties do not agree with the plan, those interested parties may file a different plan. These parties include the **trustee** (comparable to the UK's Official Receiver), a creditors' committee or single creditor, an equity security holders' committee or single equity security holder, an indenture trustee). The plan must be approved by the creditors to go ahead.

The committees mentioned above may be appointed by the **US Trustee** (a court appointed official) as soon as the order has been granted. He must appoint a committee of unsecured creditors, but may also form other committees.

In most cases, **management** are retained to carry out the plan of reorganisation but a trustee may be appointed if mismanagement or fraud is suspected.

This is a key difference from the UK, where an **administrator** is appointed and the powers of management are subjugated to his powers. In the UK it is the administrator who comes up with a plan of action in administration, which has to be approved by creditors.

Achieving the plan of reorganisation

A key aspect of the US method which has no parallel in the UK is the concept of **super-priority financing**. This means that a US company can obtain additional financing to implement the plan of reorganisation, which is then given extra priority over other debts.

20 Boards

Top tips. This question is very straightforward if you have covered the material properly.

(a) **Non-executive director**

A non-executive director is a fully appointed director of the company who does not have executive powers ie does not have a functional role in the company's management. Non-executive directors' primary duty is to attend meetings of the board, at which they are expected to play an objective, questioning role.

(b) **Executive director**

An executive director is a **director who performs a specific role in a company** under a service contract which requires a regular, possibly daily involvement in management.

Such directors are often employees of the company, and if they have **specific management duties**, they are often given a relevant title, for example, finance director or sales director.

The contrasting type of director, often found in listed, public companies where they are a requirement of the Combined Code, are non-executive directors, who simply serve on the board of directors.

(c) **Single board**

A single, sometimes known as unitary, board is the typical board structure in the UK and the US and many other countries. It is **where the company is managed by a single board of directors**.
Such a board may simply comprise executive directors, but may also include non-executive directors, particularly in listed, public companies, where a combination of executive and non-executive directors is encouraged by the corporate governance codes.

The single board has collective responsibility to manage the company and has power delegated to it as a collective body.

(d) **Supervisory board**

The supervisory board is the superior board in a system used in Germany, Holland and some other countries, where there is a **dual-board system** comprising a **management board** and a **supervisory board**.

The supervisory board (known as Aufsichsrat in Germany) consists of members elected by the shareholders and the employees and it has an advisory role in relation to the business. It also carries out certain duties, such as electing members of the management board and receiving reports from the management board on company business.

21 Criminal and civil law

Top tips. You should be able to distinguish between criminal and civil law fairly easily. It is important, of course, to take care not to confuse the two types of 'civil' law in your syllabus. In this case it should be reasonably straightforward what type of civil law is required for two reasons: first, it is connected with a question about criminal law (civil and criminal law being two important classifications of types of law) and second, the question specifically states that you do it with reference to the English legal system. As this is a common law system, it would be nonsense to put together an answer about civil law systems.

(a) **Criminal and civil law**

(i) **Criminal law**

A crime is **conduct prohibited by the state**. Criminal law therefore deals with acts which specifically breach the law of a state. Persons found guilty of crimes are usually **punished** by being required to pay fines to the state or imprisonment. What constitutes individual crimes will vary from state to state and individual states will set out in law what conduct is prohibited.

In England, criminal offences are prosecuted in the criminal court system, which comprises the magistrates' courts and the crown courts, appeals from which can be made to the High Court, the Court of Appeal and then the House of Lords and European Court of Justice.

(ii) **Civil law**

Civil law exists to re**gulate rights and obligations of persons dealing with each other**. A common example of civil law is contract, where two people take on legal obligations towards one another. Again, what falls within the remit of civil law will vary from state to state. For example, in a nation where land is privately owned, trespass (unauthorised entry to land) may be a civil offence, whereas in countries where land is primarily owned by the state, trespass might be a criminal offence. Civil offences usually result in compensation for the wronged party rather than punishment for the wrongdoer.

In England, civil offences are pursued in the civil court system which comprises the county courts, the High Court, and then the courts of appeal as laid out above in the criminal system (although the case will be tried in different divisions of those courts).

(b) **Money laundering**

Money laundering is the term given to **attempts to make the proceeds of crime appear respectable**. It covers any activity by which the apparent source and ownership of money representing the proceeds of income are changed so that the money appears to have been obtained legitimately.

The Vienna Convention requires countries to criminalise money laundering. As the description given of money laundering above is quite wide, this may result in **several different criminal offences**. The Financial Action Task Force, an international body set up to develop policies to counter money laundering recognises that measures may have to be different in different states.

In the UK, five criminal offences have been created in relation to money laundering. They are:

- **Assisting** another to retain the proceeds of criminal conduct
- **Acquisition, possession or use** of the proceeds of criminal conduct
- **Concealing** the proceeds of criminal activity
- **Failure to disclose** knowledge or suspicion of money laundering
- **Tipping off** (disclosing information to any person if disclosure may prejudice an investigation into:
  - Drug trafficking
  - Drug money laundering
  - Terrorist related activities
  - Laundering the proceeds of criminal conduct)

Why should money laundering be a criminal offence?

Typically, **money laundering allows other crimes to be committed**. Money laundering involves making money made through criminal activity appear respectable. It may then be used to fund other crimes. The act of 'recycling' the money for criminal use is **contrary to state policy**. It follows that it is therefore an act which the state should prohibit.

The Vienna Convention encourages all states to criminalise the activity. This is because money laundering can be carried out across national boundaries, especially when states have agreements with one another about the free movement of people and their money. Failure by some countries to criminalise the activity compromises the criminalisation of the activity in other nations as the criminals may simply make their money appear respectable in a nation where it is legal to do, thus minimising their potential exposure for criminal activities and in order to continue them.

22 Financial Services Authority

Top tips. This question is not broken down into parts, so it is important that you read it very carefully and answer all the relevant parts of the question. It requires you to explain the role of the FSA in respect of company markets. This will involve an explanation of what the FSA is. It then asks you to pay particular attention to market abuse and money laundering. Both of these concepts will also require definition as you explain what the FSA does in respect of them. To score highly you need to write a complete, well-balanced answer, and not fall into the trap of writing about anything not required by the question, for example, other roles that the FSA has.

Financial Services Authority (FSA)

The Financial Services Authority is the regulator of the financial services industry and company markets and share exchanges in the UK. In this answer, we shall concentrate on its role with regard to companies. It is not a government agency, but has links to the government. It is a private limited company of which the UK government's treasury department is the guarantor. It is financed by the financial services industry.

Companies

Specifically in relation to companies, the FSA approves companies for listing in the UK, supervises companies and has powers of enforcement with relation to companies. Two of its aims are to secure an appropriate degree of protection for consumers in the market and to reduce the scope for financial crime (for example, market abuse and money laundering, both of which we consider below in more detail below).

The FSA is authorised to carry out investigations of companies when the following matters are suspected:

- Market abuse
- Misleading statements and practices
- Insider dealing
- Breaches of the Listing Rules of the Stock Exchange
- Money laundering

The power to make such investigations is shared with the Government's Department of Business Enterprise and Regulatory Reform.

Market abuse

Market abuse is behaviour by one person or in concert which occurs in the UK in relation to qualifying investments traded on a designated market, which satisfies one of the prescribed conditions and which is likely to be regarded by a regular user of the market, who is aware of the behaviour, as a **failure** on the part of the person or persons concerned to observe the **standard of behaviour** reasonably expected of a person in his position in relation to the market: Financial Services and Markets Act 2000. It is improper conduct that undermines UK financial markets or damages the interests of ordinary market participants.

Market abuse could consist of **misuse of information**, **market distortion**, creating a **false or misleading impression**, recklessly making a statement, promise or forecast that was **misleading**, **false** or **deceptive**, or inducing **another person** to exercise or to refrain from exercising rights in relation to investments.

The description of market abuse above shows that it is quite a judgemental exercise determining whether a party has committed the offence. The FSA has a key role in making that determination. It achieves this by:

- Issuing a **Code of Market Conduct**, to set a standard of behaviour that is deemed acceptable
- Making investigations as discussed above

The FSA has statutory powers to impose unlimited fines for the offence of market abuse.

Money laundering

Money laundering is the term given to attempts to make the proceeds of crime appear respectable. It covers any activity by which the apparent source and ownership of money representing the proceeds of income are changed so that the money appears to have been obtained legitimately.

As discussed above, the FSA also has powers to conduct investigations into such activity. Money laundering is a civil offence, so the FSA will work in harness with the National Criminal Information Service and the police in respect of this crime.

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